1-1-2008

Common interest realty associations with conforming changes as of May 1, 2008; Audit and accounting guide

American Institute of Certified Public Accountants. Common Interest Realty Associations Task Force

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AUDIT & ACCOUNTING GUIDE

Common Interest Realty Associations

May 1, 2008

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Common Interest Realty Associations

WITH CONFORMING CHANGES AS OF
MAY 1, 2008

AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

AICPA®

This edition of the AICPA Audit and Accounting Guide *Common Interest Realty Associations*, which was originally issued in 1991, has been modified by the AICPA staff to include certain changes necessary because of the issuance of authoritative pronouncements since the guide was originally issued and other changes necessary to keep the guide current on industry and regulatory matters. The changes made are identified in a schedule in appendix F of the guide. The changes do *not* include all those that might be considered necessary if the guide were subjected to a comprehensive review and revision.

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ISBN 978-0-87051-742-6

Notice to Readers

This Audit and Accounting Guide presents recommendations of the Common Interest Realty Associations Task Force on the application of generally accepted auditing standards to audits of financial statements of common interest realty associations. This guide also presents the task force's recommendations on and descriptions of financial accounting and reporting principles and practice for common interest realty associations. The AICPA Accounting Standards Executive Committee has found this guide to be consistent with existing standards and principles covered by Rules 202, *Compliance With Standards*, and 203, *Accounting Principles* (AICPA, *Professional Standards*, vol. 2, ET sec. 202 and 203, respectively), of the AICPA Code of Professional Conduct. AICPA members should be prepared to justify departures from the accounting guidance in this guide, as discussed in paragraph .07 of AU section 411, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles (AICPA, *Professional Standards*, vol. 1)[*]

Auditing guidance included in an AICPA Audit and Accounting Guide is interpretive pursuant to AU section 150, *Generally Accepted Auditing Standards* (AICPA, *Professional Standards,* vol. 1). Interpretive publications are recommendations on the application of Statements on Auditing Standards (SASs) in

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[*] On May 9, 2008, the Financial Accounting Standards Board (FASB) issued FASB Statement No. 162, *The Hierarchy of Generally Accepted Accounting Principles*, which identifies the sources of accounting principles and the framework for selecting the principles used in the preparation of financial statements of nongovernmental entities that are presented in conformity with generally accepted accounting principles (GAAP) in the United States (the GAAP hierarchy). The FASB concluded that the GAAP hierarchy should reside in the accounting literature established by the FASB rather than in the auditing literature established by the AICPA (for non-Securities and Exchange Commission [SEC] registrants) or the Public Company Accounting Oversight Board (PCAOB) (for SEC registrants).

FASB Statement No. 162 carries forward the GAAP hierarchy as set forth in the AICPA's AU section 411, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles (AICPA, *Professional Standards*, vol. 1), subject to certain modifications that the FASB does not expect to result in changes to current practice. The modifications include, among other changes, the expansion of category (*a*) accounting principles to include, with one exception, all sources of accounting principles that are issued after being subject to the FASB's due process (including, but not limited to, FASB Staff Positions and FASB Statement No. 133 implementation issues, which are currently not addressed in AU section 411). Although certain consensus positions of the FASB Emerging Issues Task Force (EITF) have been issued after being subjected to the FASB's due process, the FASB decided to carry forward the categorization of EITF consensuses as presented in AU section 411, which is category (*c*).

FASB Statement No. 162 does not carry forward the exception permitted in Rule 203, *Accounting Principles* (AICPA, *Professional Standards*, vol. 2, ET sec. 203), of the AICPA's Code of Professional Conduct that allows departures from the GAAP hierarchy if the member can demonstrate that, due to unusual circumstances, the financial statements would otherwise have been misleading. Therefore, an entity cannot represent that its financial statements are presented in accordance with GAAP if its selection of accounting principles departs from the GAAP hierarchy set forth in FASB Statement No. 162, and that departure has a material effect on its financial statements.

FASB Statement No. 162 is effective 60 days following the approval by the SEC of the conforming amendments included in PCAOB Release No. 2008-001 adopted by the PCAOB on January 29, 2008. Among other significant provisions, the conforming amendments remove the GAAP hierarchy from the PCAOB's interim auditing standards. The PCAOB and the FASB coordinated efforts so that the effective date of FASB Statement No. 162 would coincide with that of the PCAOB's conforming amendments removing the GAAP hierarchy from its interim auditing standards.

In response to the FASB's release of the exposure draft of FASB Statement No. 162 in April 2005, the AICPA issued an exposure draft of a proposed SAS, *Amendment to Statement on Auditing Standards No. 69,* The Meaning of *Present Fairly in Conformity With Generally Accepted Accounting Principles, for Nongovernmental Entities for Nongovernmental Entities*, in May 2005, which deletes the GAAP hierarchy for nongovernmental entities from SAS No. 69. The AICPA anticipates that the effective date of this proposed SAS will coincide with that of FASB Statement No. 162. For more information, please visit the FASB Web site at www.fasb.org and the PCAOB Web site at www.pcaob.org.

specific circumstances, including engagements for entities in specialized industries. An interpretive publication is issued under the authority of the AICPA Auditing Standards Board (ASB) after all members have been provided an opportunity to consider and comment on whether the proposed interpretive publication is consistent with the SASs. The members of the ASB have found this guide to be consistent with existing SASs.

The auditor should be aware of and consider interpretive publications applicable to his or her audit. If an auditor does not apply the auditing guidance included in an applicable interpretive publication, the auditor should be prepared to explain how he or she complied with the SAS provisions addressed by such auditing guidance.

This AICPA Audit and Accounting Guide, which also contains review and compilation guidance, is an interpretive publication pursuant to AR section 50, *Standards for Accounting and Review Services* (AICPA, *Professional Standards*, vol. 2). Interpretive publications include recommendations on the application of Statements on Standards for Accounting and Review Services (SSARS) in specific circumstances, including engagements for entities in specialized industries. Interpretive publications are issued under the authority of the AICPA Accounting and Review Services Committee (ARSC). The members of the ARSC have found this guide to be consistent with the existing SSARS.

An accountant should be aware of and consider interpretive publications applicable to his or her compilation or review. If the accountant does not apply the guidance included in an applicable AICPA Audit and Accounting Guide, the accountant should be prepared to explain how he or she complied with the SSARS provisions addressed by such guidance.

This AICPA Audit and Accounting Guide, which also contains attestation guidance, is an interpretive publication pursuant to AT section 50, *SSAE Hierarchy* (AICPA, *Professional Standards*, vol. 1). Interpretive publications include recommendations on the application of Statements on Standards for Attestation Engagements (SSAEs) in specific circumstances, including engagements for entities in specialized industries. Interpretive publications are issued under the authority of the AICPA ASB. The members of the ASB have found this guide to be consistent with the existing SSAEs.

A practitioner should be aware of and consider interpretive publications applicable to his or her attestation engagement. If the practitioner does not apply the guidance included in an applicable AICPA Audit and Accounting Guide, the practitioner should be prepared to explain how he or she complied with the SSAE provisions addressed by such guidance.

FASB Accounting Standards Codification™

On January 15, 2008, the FASB launched the 1-year verification phase of the *FASB Accounting Standards Codification*™ (codification). After the verification period, during which constituents are encouraged to provide feedback on whether the codification content accurately reflects existing U.S. generally accepted accounting principles (GAAP) for nongovernmental entities, the FASB is expected to formally approve the codification as the single source of authoritative U.S. GAAP, other than guidance issued by the Securities and Exchange Commission (SEC). The codification includes all accounting standards issued by a standard-setter within levels A–D of the current U.S. GAAP hierarchy, including FASB, AICPA, Emerging Issues Task Force (EITF), and related literature.

The codification does not change GAAP; instead it reorganizes the thousands of U.S. GAAP pronouncements into roughly 90 accounting topics, and displays all topics using a consistent structure. The SEC guidance will follow a similar topical structure in separate SEC sections.

This edition of the guide has not been conformed to the new codification. AICPA Audit and Accounting Guides, as well as other AICPA literature, will be conformed to reflect the codification after the verification phase and upon formal approval by the FASB.

Defining Professional Requirements

AU section 120, *Defining Professional Requirements in Statements on Auditing Standards*, and AT section 20, *Defining Professional Requirements in Statements on Standards for Attestation Engagements* (AICPA, *Professional Standards*, vol. 1), which were issued in December 2005, set forth the meaning of certain terms used in SASs and SSAEs, respectively, issued by the ASB in describing the professional requirements imposed on auditors and practitioners. The specific terms used to define professional requirements in these sections are not intended to apply to interpretive publications issued under the authority of the ASB because interpretive publications are not auditing or attestation standards. It is the ASB's intention to make conforming changes to the interpretive publications over the next several years to remove any language that would imply a professional requirement where none exists.

In December 2007, the ARSC issued AR section 20, *Defining Professional Requirements in Statements on Standards for Accounting and Review Services*, (AICPA, *Professional Standards*, vol. 2), which sets forth the meaning of certain terms used in SSARSs issued by the ARSC in describing the professional requirements imposed on accountants performing a compilation or review of a nonissuer. The specific terms used to define professional requirements in this section are not intended to apply to interpretive publications issued under the authority of the ARSC because interpretive publications are not SSARSs. It is the ARSC's intention to make conforming changes to the interpretive publications to remove any language that would imply a professional requirement where none exists.

AU section 120, AT section 20, and AR section 20, which were effective upon issuance, define the terminology that the ASB and ARSC will use going forward to describe the degree of responsibility that the requirements impose on the auditor, practitioner, or accountant in engagements performed for nonissuers. SASs, SSAEs, and SSARSs will use the words *must* or *is required* to indicate an unconditional requirement, with which the auditor, practitioner, or accountant is required to comply. SASs, SSAEs, and SSARSs will use the word *should* to indicate a presumptively mandatory requirement. The auditor, practitioner, or accountant is required to comply with a presumptively mandatory requirement in all cases in which the circumstances exist to which the presumptively mandatory requirement applies; however, in rare circumstances, the auditor, practitioner, or accountant may depart from a presumptively mandatory requirement provided he or she documents the justification for the departure and how the alternative procedures performed in the circumstances were sufficient to achieve the objectives of the presumptively mandatory requirement. If a SAS, SSAE, or SSARS provides that a procedure or action is one that the auditor, practitioner, and accountant *should consider*, the consideration of the procedure or action is presumptively required, whereas carrying out the procedure or action is not.

This guide has been updated as applicable for AU section 120, AT section 20, and AR section 20. Refer to the Schedule of Changes (appendix F) for additional information.

Recognition

Benjamin S. Neuhausen
Chair, Accounting Standards Executive Committee

Harold L. Monk, Jr.
Chair, Auditing Standards Board

Common Interest Realty Associations Task Force (1991)

Mandel Gomberg, *Chair*
Roger D. Carney
Arnold M. Dubin
Howard N. Fink
Monte Kane
Meyer M. Saltzman
Judith Weiss

AICPA Staff

Doug Bowman
Technical Manager
Accounting and Auditing Publications

Michael Glynn
Technical Manager
Audit and Attest Standards

The AICPA gratefully acknowledges those who reviewed and otherwise contributed to the development of this guide: Gayle L. Cagianut, Steve Feldman, Jules C. Frankel, Mitchell H. Frumkin, Monte Kane, Gary Porter, and Clifford J. Treese.

Guidance Considered in This Edition

This guide has been modified by the AICPA staff to include certain changes necessary due to the issuance of authoritative pronouncements since the guide was originally issued. Relevant accounting and auditing guidance contained in official pronouncements issued through May 1, 2008, has been considered in the development of this edition of the guide. This includes relevant guidance issued up to and including the following:

- FASB Statement No. 161, *Disclosures about Derivative Instruments and Hedging Activities—an amendment of FASB Statement No. 133*
- Revised FASB Statements issued through May 1, 2008, including FASB Statement No. 141(R), *Business Combinations*
- FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes—an interpretation of FASB Statement No. 109*
- FASB Technical Bulletin 01-1, *Effective Date for Certain Financial Institutions of Certain Provisions of Statement 140 Related to the Isolation of Transferred Financial Assets*
- FASB EITF consensus ratified by the FASB through May 1, 2008

- FASB Staff Positions issued through May 1, 2008
- Statement of Position (SOP) 07-1, *Clarification of the Scope of the Audit and Accounting Guide* Investment Companies *and Accounting by Parent Companies and Equity Method Investors for Investments in Investment Companies* (AICPA, *Technical Practice Aids*, ACC sec. 10,930)
- Practice Bulletin No. 15, *Accounting by the Issuer of Surplus Notes* (AICPA, *Technical Practice Aids*, PB sec. 12,150)
- SAS No. 114, *The Auditor's Communication With Those Charged With Governance* (AICPA, *Professional Standards*, AU sec. 380)
- Auditing Interpretation No. 1, "Communicating Deficiencies in Internal Control Over Compliance in an Office of Management and Budget (OMB) Circular A-133 Audit" of AU section 325, *Communicating Internal Control Related Matters Identified in an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 9325 par. .01–.04)
- SOP 07-2, *Attestation Engagements That Address Specified Compliance Control Objectives and Related Controls at Entities That Provide Services to Investment Companies, Investment Advisers, or Other Service Providers* (AICPA, *Technical Practice Aids*, AUD sec. 14,430)
- SSAE No. 14, *SSAE Hierarchy* (AICPA, *Professional Standards*, AT sec. 50)
- Attestation Interpretation No. 6, "Reporting on Attestation Engagements Performed in Accordance With Government Auditing Standards" of AT section 101, *Attest Engagements* (AICPA, *Professional Standards*, vol. 1, AT sec. 9101 par. .56–.58)
- SSARS No. 17, *Omnibus Statement on Standards for Accounting and Review Services—2008* (AICPA, *Professional Standards*, vol. 2)
- Accounting and Review Services Interpretation No. 29, "Reporting on an Uncertainty, Including an Uncertainty About an Entity's Ability to Continue as a Going Concern" of AR section 100, *Compilation and Review of Financial Statements* (AICPA, *Professional Standards*, vol. 2, AR sec. 9100 par. .120–.129)

Users of this guide should consider pronouncements issued subsequent to those listed previously to determine their effect on entities covered by this guide. In determining the applicability of a pronouncement, its effective date should also be considered.

The changes made to this edition of the guide are identified in the Schedule of Changes (appendix F). The changes do not include all those that might be considered necessary if the guide were subjected to a comprehensive review and revision.

Auditing Guidance Included in This Guide

Risk Assessment Standards

In March 2006, the ASB issued SAS Nos. 104–111 (the "risk assessment standards"). Collectively, the risk assessment standards establish standards and provide guidance concerning the auditor's assessment of the risks of material misstatement (whether caused by fraud or error) in a nonissuer financial statement audit; design and performance of tailored audit procedures to address assessed risks; audit risk and materiality; planning and supervision; and audit evidence. The most significant changes to existing practice that the auditor will be required to perform are as follows:

- Obtain a more in-depth understanding of the audited entity and its environment, including its internal control
- Perform a more rigorous assessment of the risks of where and how the financial statements could be materially misstated (defaulting to a maximum control risk is not acceptable)
- Provide a linkage between the auditor's assessed risks and the nature, timing, and extent of audit procedures performed in response to those risks

The statements are effective for audits of financial statements for periods beginning on or after December 15, 2006. Early adoption is permitted. See appendix E in this guide for a more detailed comparison between the risk assessment standards and the existing standards. This guide has been conformed to the new risk assessment standards.

For additional guidance on the risk assessment standards, please refer to the AICPA Audit Guide *Assessing and Responding to Risk in a Financial Statement Audit* (product no. 012456) and the AICPA Audit Risk Alert *Understanding the New Auditing Standards Related to Risk Assessment* (product no. 022526).

Defining Professional Requirements

As previously stated, this guide has been conformed, as applicable, to the standards found in AU section 120, AT section 20, and AR section 20, which were effective upon issuance (December 2005, except for AR section 20, which was issued in December 2007). These new standards define the terminology that the ASB and ARSC will use going forward to describe the degree of responsibility that the requirements impose on the auditor, practitioner, or accountant in engagements performed for nonissuers. Refer to the Schedule of Changes, appendix F, for additional information.

Preface

Purpose and Applicability

This Audit and Accounting Guide has been prepared

- to provide background information on the nature and characteristics of common interest realty associations (CIRAs);
- to assist management, which has the primary responsibility for the financial statements, in applying generally accepted accounting principles; and
- to assist independent public accountants in conducting compilations, reviews, and audits of financial statements of CIRAs.

This guide also describes conditions and procedures unique to the industry and illustrates the form and content of the financial statements of CIRAs as well as informative disclosures relating to such statements.

Limitations

This guide does not discuss the application of all generally accepted accounting principles (GAAP) and all generally accepted auditing standards (GAAS) that are relevant to the preparation and audit of financial statements of CIRAs. This guide is directed primarily to those aspects of the preparation and audit of financial statements that are unique to CIRAs or are considered particularly significant to them.

This Audit and Accounting Guide provides guidance on the following matters:

- *Financial reporting of common property and facilities*. This guide provides guidance for the reporting of assets, other than common real property, maintained or owned by a CIRA. This guide describes practice for the reporting of common real property maintained or owned by a CIRA. The effect of the manner in which the assets were acquired and depreciation policies are also discussed.
- *Major repairs and replacements*. Because a CIRA's primary function is to maintain and replace common property, some CIRAs' legal documents and some state statutes require them to accumulate funds for future major repairs and replacements. Disclosure of such designated funds and supplementary disclosures of anticipated major repairs and replacements are discussed.
- *Financial reporting*. The widespread use of financial reports of CIRAs by potential buyers, lenders, sellers, and others creates a need for financial statement formats that are comparable. A recommended format is discussed and illustrations are presented in appendix A.
- *Method of accounting*. Under GAAP, CIRAs report their financial activities using the accrual basis of accounting. Alternatively, the cash basis of accounting may be used if the results of applying that basis do not differ substantially from the results using the accrual basis. This guide discusses the various methods.

- *Budgets*. CIRAs are generally required by their governing documents to base members' assessments on annual budgets. This guide discusses the development of budgets and their implementation in the operations of CIRAs.
- *Income taxes*. The IRS considers most CIRAs to be taxable entities that are required to file federal income tax returns. Guidelines for determining the tax filing alternatives for CIRAs are discussed in this guide.
- *Audit considerations*. Audit procedures specifically applicable to CIRAs are discussed.
- *Review and compilation engagements*. Because many CIRA engagements are compilations or reviews, procedures specifically applicable to CIRAs are discussed.
- *Cooperative housing corporations*. Issues unique to audits of cooperative housing corporations and financial reporting requirements for these entities are discussed.

Effective Date

The provisions of this guide, as originally issued in 1991, should be applied to financial statements for periods beginning on or after September 15, 1991. Earlier application is encouraged. The effects of reporting accounting changes caused by implementing this guide should be reported retroactively.

References to Professional Standards

This guide presents auditing guidance to help the auditor plan, conduct, and report the results of an audit in accordance with GAAS. In citing the professional standards, references are made to AICPA *Professional Standards*. Additionally, when referencing professional standards, this guide cites section numbers and not the original statement number, as appropriate. For example, Statement on Auditing Standards No. 54, *Illegal Acts by Clients*, is referred to as AU section 317.

This guide also presents compilation and review guidance to help the accountant understand and apply the performance and communication requirements set forth in the Statements on Standards for Accounting and Review Guidance (SSARs) included in AICPA *Professional Standards*. In citing the professional standards, references are made to AICPA *Professional Standards*. Additionally, when referencing professional standards, this guide cites section numbers and not the original statement number, as appropriate. For example, SSARS No. 14, *Compilation of Pro Forma Financial Information* is referred to as AR section 120.

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Chapter 1

Industry Background and Unique Characteristics

General Description and History

1.01 Although housing cooperatives have been around since the 1920s, and planned unit developments (PUDs) since the 1840s, it was not until new forms of real estate ownership, such as condominiums and time-shares emerged in the 1960s that the terms used to describe them became common. Collectively, these forms of real estate ownership are defined as *common interest communities* (CICs). A key feature of CICs is the existence of an association of owners, referred to in this guide as a *common interest realty association* (CIRA), which is responsible for providing certain services and maintaining certain property that all the owners share or own in common. Homeowners' associations (HOAs) and condominium associations are two examples of CIRAs.

1.02 The main characteristics of such ownership are the following:

- Individual ownership of a lot, defined interior space, or shares of stock
- Ownership of an undivided interest in the common property, with all owners bound by covenant, restriction, or contract through an association of owners
- Automatic membership in a CIRA that has been established under state laws and that performs maintenance and other service activities for the owners
- Funding of the CIRA's activities by periodic assessments of all owners

Condominiums

1.03 The term *condominium* indicates a legal form of ownership in which each owner has title to a defined interior space within a building or combination of buildings[1] and an undivided ownership interest in *common property* within a development, such as the grounds, recreational facilities, and exteriors of buildings shared in common with all other owners. A *condominium association* generally owns no real property, but it is responsible for maintaining the common property and providing necessary services. In certain jurisdictions, condominiums may be established as condominium trusts; such entities may own the real estate and all the improvements. If they do, the accounting and reporting for condominium trusts are the same as for cooperatives.

Planned Unit Developments

1.04 A PUD is a form of land development in which various residential and nonresidential structures are clustered to allow optimal use of the property

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[1] The ownership of a defined interior space in a condominium is referred to as a *unit* in subsequent discussions in this guide.

and to provide certain open spaces and amenities not otherwise available in traditional forms of subdivision developments. In many PUDs, tracts of land are set aside for all owners to use for active or passive recreational purposes, parking areas, and streets.

1.05 To become an owner in a PUD, one buys a lot and improvements on the lot. The title to common property is held by a CIRA, generally an HOA, which has obtained it at no cost to the association. The CIRA assesses owners for funds needed to maintain common property and provide necessary services.

Cooperatives

1.06 The term *cooperative* refers to a form of ownership in which a corporation owns the real estate, including all of the improvements, and is responsible for its maintenance, debt service, repairs, and so forth. The owners do not own any of the real estate, but they own shares of stock of the corporation. Their ownership interests permit them only to lease from the cooperative, to occupy their individual units, or to sell their shares. Members are assessed carrying charges for units they occupy or lease. The corporation functions in the same way as other CIRAs in maintaining real estate and providing services.

Time-Share Developments

1.07 A time-share is a form of ownership in which each owner has a time-share interest, commonly referred to as *interval use*, that represents a right to use a unit in a time-share development for a specified number of weeks during a year. Such interests may be in a form of (*a*) fee simple ownership, evidenced by a deed that specifies the amount of time the deedholder is entitled to use the unit, or (*b*) a lease giving the owner the right to use a unit for a predetermined lease term. These types of entities may also be referred to as *fractional ownership associations*.

Regulatory Framework

1.08 CIRAs derive their authority for all matters, including financial matters, from specific statutes and legal documents. CIRAs operate under the following:

- General state statutes, such as corporate statutes or not-for-profit corporate statutes
- Specific state statutes, such as state horizontal property acts or state condominium acts
- Declarations of covenants, conditions, and restrictions (CC&Rs), declarations of condominium, or master deeds (for condominiums and HOAs)
- Membership agreements and proprietary leases (for cooperatives)
- Articles of incorporation or association
- Bylaws
- Boards of directors' actions (including house rules and policies)

General State Statutes

1.09 Most CIRAs are subject to state corporate or not-for-profit corporate statutes, unless they are specifically excluded. HOAs normally are incorporated to permit them to hold title to common property and to limit their liability. Depending on the nature of the state statute, not all condominium associations are incorporated.

1.10 CIRAs that are corporations are also subject to corporate statutes that prescribe broad provisions within which corporations function, including, for example, provisions for annual reporting requirements, participation by members, and protection of assets.

Specific State Statutes

1.11 Generally, no unique state statutes are necessary to create cooperatives or HOAs. However, specific state enabling statutes are necessary to create the condominium form of ownership. By 1969, all states had adopted some form of condominium or horizontal property statute. Some of these are simple enabling statutes that briefly describe the format for creating condominiums, whereas others prescribe operational and developmental procedures for condominium developers, managers, and boards of directors. A specific state statute for CIRAs generally supersedes conflicting provisions of general statutes and possibly supersedes the documents of a CIRA that are subject to it. Such statutes are frequently revised.

1.12 In an effort to provide guidance for statutory models at the state level, the National Conference of Commissioners on Uniform State Laws (NCCUSL) promulgated the federal Uniform Common Interest Ownership Act in 1982 (amended in 1994). It combined, in a single comprehensive law, prior uniform laws in this area of real estate ownership (the Uniform Condominium Act [1980], the Uniform Planned Community Act [1980]), and the Model Real Estate Cooperative Act [1981]). A related uniform act promulgated around this same time was the Uniform Real Estate Time-Share Act (1982). As background information, the NCCUSL is a body of lawyers, professors, legal scholars, and other professionals who work toward the standardization of laws across the various U.S. states. The NCCUSL does not have any legislative power; uniform acts become laws only to the extent that they are enacted into law by state legislatures. State legislatures do not have to enact the precise language of a uniform act and often enact laws with at least some modifications.[*]

Declarations and Master Deeds

1.13 To establish the rules under which CIRAs exist and function, HOAs use declarations of covenants on the land, and condominium associations use condominium declarations or master deeds. Declarations of CC&Rs and declarations of condominium or master deeds are the fundamental governing documents of CIRAs. Typically, they state the owners' rights and restrictions on the

[*] A drafting committee of the National Conference of Commissioners on Uniform State Laws has issued a discussion draft, dated October 2005, proposing amendments to the Uniform Common Interest Ownership Act. The committee will consider a number of topics, including owner access to budget and financial records of the association, the establishment and funding of reserve accounts, and issues to improve the usefulness of the act. See the University of Pennsylvania Law School Web site at www.law.upenn.edu/bll/archives/ulc/ucioa/2005AMDraftComments.htm for more information.

use of common property as well as their obligations to participate in governing and funding CIRAs.

Membership Agreements and Proprietary Leases

1.14 Membership agreements and proprietary leases are unique to cooperatives. A membership agreement or subscription agreement is executed between a member and a cooperative and establishes the terms of ownership, including restrictions on resales. A proprietary lease or occupancy agreement is also executed between an owner and a cooperative and establishes the terms of occupancy of a particular unit. These documents create certain ownership rights and obligations.

Articles of Incorporation

1.15 Articles of incorporation may or may not be used by a CIRA, depending on its state's statutes. Articles of incorporation often are not required in states with statutes directed to CIRAs. They are used only to provide a broad framework within which a CIRA's corporate structure functions.

1.16 Cooperative corporations own the real estate and may or may not have covenants to restrict its use. Cooperatives are governed through the articles of incorporation, the fundamental legal document, and other documents providing for the use of leasehold space, apartments, and homes.

Bylaws

1.17 Bylaws are organizational documents used to establish the specific operating procedures of CIRAs for such matters as meetings, voting procedures, leadership positions, duties and responsibilities of specific officers, and committees. The declaration and the articles of incorporation always take precedence over the bylaws.

Board of Directors' Actions

1.18 The policies, procedures, and resolutions of a CIRA's board of directors are established to carry out the association's responsibilities as prescribed in the declaration or articles of incorporation and the bylaws, and they set forth internal operating practices for handling financial and other matters.

1.19 The board of directors adopts rules, regulations, and policies that deal mostly with restrictions on the use of property and on the behavior of unit owners. Financial matters occasionally are prescribed in the rules and regulations, particularly those concerning delinquent assessments.

Federal Legislation and Regulatory Considerations

1.20 The operations of CIRAs are regulated by the individual states and not by the federal government. Federal regulations, court cases, revenue rulings, and federal legislation, however, apply to the income tax treatment of CIRAs, as discussed in chapter 6. In addition, various federal and quasi-federal lending and lending-related organizations, such as the Federal Housing Administration, the Department of Veterans Affairs, the FreddieMac and the FannieMae, have regulations to guide developers and others in establishing CIRAs as well as in the sales and financing of units. The legal documents of CIRAs may contain language to serve the needs and regulations of such organizations.

Although compliance with such regulations may not be mandatory, many believe that CIRAs should seek to comply with them, if practical, to facilitate sales and resales, because not doing so may restrict available sources of funds and secondary financing.

Creation and Governance of CIRAs

1.21 The establishment of a CIRA as a legal entity and the transfer of control of the CIRA from the declarant (developer or converter), who established the CIRA, to unit owners may involve competing interests and potential problems. The establishment of a CIRA and transfer of control are discussed in the legal documents of most CIRAs. Before the declarant can sell units or shares, the declarant must file legal documents that create the CIRA and specify its nature, form, powers, and duties. The legal documents provide for the election of a board of directors and state its duties, responsibilities, and authority.

1.22 All CIRAs are governed substantially the same way regardless of their legal form. A board of directors of individual unit owners usually is elected from among all owners to serve as a governing body. A CIRA's board of directors is responsible for guiding the CIRA's administration; setting its policies; establishing budgets and assessments; managing its finances; approving the financial statements; and directing consultants, contractors, and staff in carrying out the CIRA's operations.

1.23 The declarant appoints or elects the first board of directors. Directors are replaced and additional directors are elected from among unit owners through a process specified in the statutes or the documents. Transfer of control from the declarant to the unit owners, however, may not be gradual if the provisions of the documents specify that a completely new board should be elected from unit owners when a stated percentage of units has been sold or at a specific subsequent date.

1.24 Whatever the transfer procedure may be, there is normally a period when the declarant controls both the CIRA and the development company. That situation may create a potential conflict with the unit owners' interests, such as in the allocation of expenses between the periods before and after control shifts from the development company to the unit owners.

1.25 The legal documents may include provisions limiting the CIRA's operations during the project's development to prevent the CIRA from acting in a manner that may harm that process. Such limitations may continue to be imposed until the declarant's majority control of the board of directors has shifted to unit owners, or until the declarant has completed selling units. Even after majority control on the board of directors has shifted, the declarant may still be able to influence the CIRA's actions, because the declarant usually retains the right to vote on behalf of unsold units.

1.26 Among other factors affecting the nature of the entity, an auditor engaged by a CIRA should gain an understanding of the effects, if any, of the declarant's influence on the CIRA's financial condition during the initial operating period in which the developer (declarant) generally controls the CIRA's management, policy setting, and finances. (The initial operating period is discussed further in paragraph 7.38.)

Management of CIRAs

1.27 CIRAs are managed in various ways. For example, while some CIRAs contract with community association management companies, others hire employees to work directly for the board of directors and carry out its management responsibilities. Still other CIRAs rely almost exclusively on volunteer management and occasional contractors and consultants, as needed.

1.28 Management personnel, on staff or by contract, are primarily responsible for the CIRA's financial administration as well as the physical maintenance of the property or the supervision of contractors that physically maintain the property.

1.29 In most CIRAs, management personnel or designated volunteers prepare periodic financial reports for the board of directors. Such reports may or may not be available to unit owners. Most CIRAs, however, have annual meetings at which financial statements for the preceding year and budgets for the following year are presented to unit owners. Financial statements may also be provided to others, such as the CIRA's insurance agents, lenders on individual unit mortgages, lenders on the CIRA's mortgages in cooperatives, prospective buyers of new or resale units, and local and state regulatory agencies.[2]

1.30 CIRAs often retain legal counsel to assist in enforcing their rules and for other purposes. CIRAs engage accountants to provide accounting, auditing, tax, and consulting services to CIRAs.

Unique Characteristics of CIRAs

1.31 The following characteristics are common to all CIRAs:

- A CIRA's functions are to operate, preserve, maintain, repair, and replace common property and provide other services. Its activities relate primarily to these functions. CIRAs generally provide services such as security guards, swimming pool lifeguards, snow removal, and rubbish removal.
- A CIRA's members pay dues and other assessments to the association for the operation of common property with collection enforceable through lien rights on their ownership interest. Members expect to receive benefits in the form of maintenance and replacement of the common property, among other governance activities performed by the CIRA.
- Membership in a CIRA is generally mandatory for owners and is a condition in the agreement to purchase either shares in a cooperative or a unit in a condominium or HOA.

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[2] In January 2005, Auditing Interpretation No. 15, "Auditor Reports on Regulatory Accounting or Presentation When the Regulated Entity Distributes the Financial Statements to Parties Other Than the Regulatory Agency Either Voluntarily or Upon Specific Request," of AU section 623, *Special Reports* (AICPA, *Professional Standards*, vol. 1, AU sec. 9623 par. .96–.98), was issued. The interpretation provides guidance as to what report the auditor should use if the financial statements and report are intended for use by parties other than those within the entity and one or more regulatory agencies to whose jurisdiction the entity is subject or the financial statements and report are distributed by the entity to parties other than the regulatory agencies to whose jurisdiction the entity is subject, either voluntarily or upon specific request.

- A CIRA's members have defined ownership interests that they can transfer to buyers of their shares or units and are entitled to share in the distribution of resources in the event of liquidation.

- A CIRA's excess of assessments over expenses at year end may be distributed to members, credited toward members' assessments in the following year, or allocated to a major repairs and replacements fund, depending on actions taken by the board of directors, requirements of the governing documents, or state statutes.

Users of Financial Statements of CIRAs

1.32 The rapid growth of CIRAs has created a corresponding growth in the demand for financial information to satisfy the needs of users of the financial statements of such entities.

1.33 The primary users of the financial information of a CIRA are unit owners, whose periodic payments of assessments or carrying charges enable the CIRA to perform its functions. They are primarily interested in information that indicates whether assessments are used for their designated budgetary purposes, and information helpful in determining the adequacy of funds accumulated for future major repairs and replacements. Adequate financial reporting may assist owners in assessing the extent to which the CIRA is meeting its responsibilities to maintain the common property.

1.34 Members of a CIRA's board of directors need timely, comprehensive financial information to make financial decisions. Information on operating expenses and capital expenditures is a vital tool for identifying unusual trends and fluctuations in operating costs and, ultimately, in determining the assessments or carrying charges that a CIRA should collect from its members.

1.35 An understanding of a CIRA's financial condition is helpful to potential buyers in assessing their possible investments. A CIRA's financial statements revealing that the CIRA has a deficit in operating funds or that it has not obtained funds needed for property replacements or major repairs may alert a prospective buyer to seek other investment opportunities or to modify the offer. In contrast, financial information indicating that a CIRA is fiscally sound may help owners sell their units and enhance the value of individual units.

1.36 Other parties that may be interested in a CIRA's financial statements include the following:

- Lenders that hold the financing on the property during the development period

- Second mortgage lenders

- Direct lenders to buyers of units

- Government lending-related organizations

- Trade vendors

- Federal, state, and local taxing authorities

- Insurers
- State agencies

1.37 Financial information about amounts due from unit owners and about a CIRA's policies for accumulating funds to meet future major repair and replacement costs on common property is a major concern of lenders, as well as of unit owners and prospective unit owners.

Chapter 2

Reporting on Common Property

2.01 Common property of a CIRA includes all real property to which title or other evidence of ownership is held (*a*) by individual members in common or (*b*) by the common interest realty association (CIRA) directly, as indicated by a CIRA's declaration or covenants. (Paragraphs 1.01–.08 of this guide discuss the ways in which title to, or other evidence of ownership of, common property of various kinds of CIRAs is held.) It also includes personal property, such as furnishings and recreational and maintenance equipment, that is owned by the CIRA and used on common real property. Each member of a CIRA has a beneficial or undivided interest in the property.

Methods of Acquisition of Common Property

2.02 A CIRA can acquire common property in various ways. For example, it may receive the property by transfer from the developer, it may buy property formerly leased by members or by the CIRA, or it may buy property on the open market.

Property Transferred by the Developer

2.03 During the development of a common interest realty project, the developer or converter determines which property, real or personal, will be common property. In a condominium, each unit owner usually holds legal title to an undivided interest in property constituting common property. In contrast, homeowners' associations (HOAs) usually have legal title to such property.

2.04 Developers or converters occasionally transfer to CIRAs property not specifically mentioned in the governing documents. Title to such property is usually conveyed to CIRAs and may be transferred before or after control of the CIRA is turned over to the unit owners. Such property may include unsold residential units, furniture and equipment, parcels of land, improvements, and commercial units. A CIRA may obtain some of those kinds of real or personal property from legal settlements of claims against the developer or converter.

Property Bought by CIRAs

2.05 CIRAs may use their own funds to pay for additions, improve the property, and replace common property. Such purchases may be funded by the following:

- Special assessments designated for acquisitions
- Cumulative excesses of normal operating revenues over normal operating expenses
- Borrowing
- Monies accumulated in the replacement fund
- Grants and similar monies from government programs for CIRAs that are used in low to moderate income housing

Property Acquired by Buying Leasehold Interests

2.06 Members of a CIRA may hold title to their units, subject to long term lease obligations, for example, on recreational facilities or land. The lessor is often an entity owned by the developer. A CIRA may negotiate on behalf of its members to buy the property from the lessor. If so, the CIRA generally holds title to the property. Funds for such purchases may be generated by assessments of members, external financing, or both. Alternatively, to be released from future lease obligations, members may buy pro rata shares of the leased facilities. If so, title is held by the members and not by the CIRA. Any portion of leased facilities not bought by members or the CIRA itself continues to be owned by the lessor.

Kinds of Common Real Property

2.07 Common real property falls into two broad categories:

- *Property that is directly associated with the unit.* This category includes common property without which the units could not be occupied and exterior property that is normally part of a freestanding unit. Examples include exterior walls, roofs, public hallways, underlying land, sidewalks, driveways, roads, some parking spaces, and greenbelts.
- *Property that is not directly associated with the unit.* This property includes community resource property that is not necessary for the primary use of the unit, although individual unit owners may benefit from its use. Examples include recreational facilities, such as swimming pools or clubhouses, managers' apartments, properties that are primarily used for commercial operations directed at non-unit owners or at unit owners for which they pay a fee based on usage.

Prevalent Industry Practice for Recognizing Common Real Property as Assets

2.08 Cooperatives recognize common real property as assets. Because of their legal structure, cooperatives have title to all their common property and have the authority to dispose of it and retain the proceeds. Other CIRAs, such as condominiums and HOAs, have adopted other practices for recognizing common real property. Paragraphs 2.09–.10 of this guide do not provide recommendations but rather describe the prevalent industry practices followed by CIRAs other than cooperatives for recognizing common real property as assets.

Real Property Directly Associated With the Units

2.09 Most CIRAs other than cooperatives, regardless of whether they have title, do not recognize as assets real property directly associated with the units.

Real Property Not Directly Associated With the Units

2.10 Most CIRAs other than cooperatives recognize real property not directly associated with the units as assets when (*a*) the CIRA has title or other evidence of ownership of the property and (*b*) either of the following conditions are met:

1. The CIRA can dispose of the property, at the discretion of its board of directors, for cash or claims to cash, with the CIRA retaining the proceeds.
2. The property is used by the CIRA to generate significant cash flows from members on the basis of usage or from nonmembers.

However, some CIRAs recognize as assets all real property to which they have title or other evidence of ownership and that is not directly associated with the units, regardless of whether condition 1 or 2 is met.

Personal Property

2.11 CIRAs should recognize common personal property, such as furnishings, recreational equipment, maintenance equipment, and work vehicles, that is used by the CIRA in operating, preserving, maintaining, repairing, and replacing common property and providing other services as assets.

Measurement of Common Property Recognized as Assets

2.12 Common property recognized as assets of a CIRA should be measured at the CIRA's cost to acquire it if the CIRA acquired the property in a monetary transaction. If the CIRA acquired the property in a nonmonetary transaction, such as by a nonreciprocal transfer from the developer, and if the property is recognized as an asset of the CIRA, the CIRA should recognize the property using fair values at the date of its acquisition. It may be helpful to consider the developer's cost, if it is known, in determining those fair values. Financial Accounting Standards Board (FASB) Statement No. 157, *Fair Value Measurements*, discussed in the following paragraphs in this chapter, provides guidance on fair value measurements.

Fair Value Measurements

2.13 FASB Statement No. 157, issued in September 2006, defines fair value, establishes a framework for measuring fair value, and expands disclosures about fair value measurements. This statement does not require any new fair value measurements. Rather, it changes current practice by establishing a single definition of fair value. FASB Statement No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities—Including an amendment of FASB Statement No. 115*, issued in February 2007, creates a fair value option under which an organization may irrevocably elect fair value as the initial and subsequent measure for many financial instruments and certain other items, with changes in fair value recognized in earnings (or another performance indicator if the business entity does not report earnings) at each subsequent reporting date as those changes occur. Most financial assets and financial liabilities are eligible to be recognized using the fair value option, as are firm commitments for financial instruments and certain nonfinancial contracts. Refer to the FASB Web site at www.fasb.org for the full text of the statements.

2.14 Except for application to certain nonfinancial assets and nonfinancial liabilities, FASB Statement No. 157, as amended by FASB Staff Position (FSP) FAS 157-2, *Effective Date of FASB Statement No. 157*, is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. Earlier application is encouraged, provided that the reporting entity has not yet issued financial statements for that fiscal year, including any financial statements for an interim period within that fiscal year. This statement shall be applied prospectively as of the beginning of the fiscal year in which this statement is initially applied, except as provided in paragraph 37 of the statement. FSP FAS 157-2 delays the effective date of FASB Statement No. 157 for nonfinancial assets and nonfinancial liabilities, except for items that are recognized or disclosed at fair value at least once a year, to fiscal years beginning after November 15, 2008. Paragraph 12 of FSP 157-2 requires entities that have not fully applied the provisions of FASB Statement No. 157 to make certain disclosures in their interim and annual financial statements. FASB Statement No. 159 is effective as of the beginning of an entity's first fiscal year that begins after November 15, 2007. Early adoption is permitted as of the beginning of a fiscal year that begins on or before November 15, 2007, provided the entity also elects to apply the provisions of FASB Statement No. 157.

Disclosures

2.15 Paragraphs 32–35 of FASB Statement No. 157 expand the disclosures required for assets and liabilities measured at fair value. For assets and liabilities that are measured at fair value on a recurring basis in periods subsequent to initial recognition or that are measured on a nonrecurring basis in periods subsequent to initial recognition, the statement requires the reporting entity to disclose certain information that enables users of its financial statements to assess the inputs used to develop those measurements. For recurring fair value measurements using significant unobservable inputs (Level 3), the reporting entity is required to disclose certain information to help users assess the effect of the measurements on earnings (or changes in net assets) for the period. FASB Statement No. 159 also establishes presentation and disclosure requirements designed to facilitate comparisons between entities that choose different measurement attributes for similar types of assets and liabilities. Organizations should report assets and liabilities that are measured using the fair value option in a manner that separates those reported fair values from the carrying amounts of similar assets and liabilities measured using another measurement attribute. To accomplish that, an organization should either (*a*) report the aggregate carrying amount for both fair value and non-fair-value items on a single line, with the fair value amount parenthetically disclosed or (*b*) present separate lines for the fair value carrying amounts and the non-fair-value carrying amounts. Refer to the FASB Web site at www.fasb.org for the full text of the statements.

Fair Value and CIRA Accounting

2.16 FASB Statement No. 159 permits all entities to elect the fair value option for many financial instruments and certain other items, including held-to-maturity securities, at specified election dates. Prior to FASB Statement No. 159, CIRAs were already required to report available-for-sale securities and trading securities at fair value, as established by FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*.

2.17 FASB Statement No. 157 affects the definition of fair values used to measure certain nonfinancial assets and liabilities, including the following types discussed in this chapter:

- Certain impaired assets and liabilities

- Goodwill and intangible assets
- Nonmonetary transactions

Impairment or Disposal of Long-Lived Assets

2.18 In conformity with FASB Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, common property that is recognized as a long-lived asset (asset group) should be tested for recoverability whenever events or changes in circumstances indicate that the carrying amount of the property may not be recoverable. An impairment loss should be recognized only if the carrying amount of a long-lived asset (asset group) is not recoverable and exceeds its fair value. The carrying amount of a long-lived asset (asset group) is not recoverable if it exceeds the sum of the undiscounted cash flows expected to result from the use and eventual disposition of the asset (asset group). That assessment should be based on the carrying amount of the asset (asset group) at the date it is tested for recoverability.[1] The impairment loss should be measured as the amount by which the carrying amount of a long-lived asset (asset group) exceeds its fair value. FASB Statement No. 157, discussed earlier in this chapter, provides guidance on fair value measurements.

2.19 When a long-lived asset (asset group) is tested for recoverability, it also may be necessary to review depreciation estimates and methods as required by FASB Statement No. 154, *Accounting Changes and Error Corrections*, or the amortization period as required by FASB Statement No. 142, *Goodwill and Other Intangible Assets*.[2] Any revision to the remaining useful life of a long-lived asset resulting from that review also should be considered in developing estimates of future cash flows used to test the asset (asset group) for recoverability. However, any change in the accounting method for the asset resulting from that review should be made only after applying FASB Statement No. 144.

2.20 Estimates of future cash flows used to test the recoverability of a long-lived asset (asset group) should include only the future cash flows (cash inflows less associated cash outflows) that are directly associated with and that are expected to arise as a direct result of the use and eventual disposition of the asset (asset group). Those estimates should exclude interest charges that will be recognized as an expense when incurred.

2.21 FASB Statement No. 144 contains additional extensive requirements about the recognition and measurement of an impairment loss and long-lived assets to be disposed of by sale and other than by sale.

2.22 The growth of common interest communities in coastal areas and other areas susceptible to adverse weather and geographical conditions has

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[1] Paragraph 10 of FASB Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, provides that for purposes of recognition and measurement of an impairment loss "a long-lived asset or assets shall be grouped with other assets and liabilities at the lowest level for which identifiable cash flows are largely independent of the cash flows of other assets and liabilities." Paragraph 11 provides that in limited circumstances, "a long-lived asset...may not have identifiable cash flows that are largely independent of the cash flows of other assets and liabilities and of other asset groups. In those circumstances, the asset group for the long-lived asset shall include all assets and liabilities of the entity."

[2] Paragraphs 19–22 of FASB Statement No. 154, *Accounting Changes and Error Corrections*, address the accounting for changes in estimates, including changes in the method of depreciation, amortization, and depletion. Paragraph 11 of FASB Statement No. 142, *Goodwill and Other Intangible Assets*, addresses the determination of the useful life of an intangible asset.

increased the industry's exposure to natural disasters. The AICPA Technical Question and Answer (TIS) section 5400.05, "Accounting and Disclosures Guidance for Losses From Natural Disasters—Nongovernmental Entities" (AICPA, *Technical Practice Aids*), identifies relevant accounting literature to consider related to the following issues that may arise upon the occurrence of a natural disaster:

1. Presentation of losses from a natural disaster (of a type that is reasonably expected to reoccur) in the statement of operations
2. Recognition of an asset impairment loss
3. Recognition of a liability for non-impairment losses and costs
4. Accounting for insurance recoveries to cover losses sustained in a natural disaster
5. Disclosures regarding the impact of a natural disaster

AICPA Technical Practice Aids provide helpful guidance in understanding and applying accounting and auditing standards and are considered *other accounting literature* (as defined in AU section 411, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles [AICPA, *Professional Standards*, vol. 1]). However, they are not sources of generally accepted accounting principles as described in AU section 411, nor are they sources of authoritative generally accepted auditing standards.

Disclosure

2.23 The following information about a CIRA's common property should be disclosed in the notes to its financial statements:

- The accounting policy for recognition and measurement of common property
- A description of common property recognized as assets in the CIRA's balance sheet
- A description of common property to which the CIRA has title, or other evidence of ownership, that is not recognized as assets in the CIRA's balance sheet
- The CIRA's responsibility to preserve and maintain the common property
- Terms and conditions of existing land or recreation leases
- Restrictions on the use or disposition of the common property

2.24 FASB Statement No. 144 contains reporting and disclosure requirements concerning impairment losses and the disposal of long-lived assets.

Depreciation

2.25 Property and equipment recognized as assets by CIRAs should be depreciated based on their estimated useful lives. The following information should be disclosed:

- Depreciation expense for the period
- Balances of major classes of depreciable assets, by nature or function, at the reporting date

- Accumulated depreciation, either by major classes of depreciable assets or in total, at the reporting date
- A general description of the method or methods used in computing depreciation for major classes of depreciable assets

Expenditures for Major Repairs or Replacements and Acquisition of Assets

2.26 CIRAs that use fund accounting should charge expenditures for major repairs or replacements to the fund or funds established for major repairs or replacements. If an expenditure from the major repairs and replacement fund relates to common property recognized as an asset, the amount expended should be reported as a transfer to the operating fund (or property fund, if such a fund is established; chapter 4 of this guide provides additional guidance about the funds in which assets should be reported). Assets transferred to the CIRA by the developer and recognized in the balance sheet should be reported as additions to the operating fund balance (or property fund, if such a fund is established).

2.27 FSP AUG AIR-1, *Accounting for Planned Major Maintenance Activities*, prohibits the use of the accrue-in-advance method of accounting for planned major maintenance activities in annual and interim financial reporting. In the FSP, FASB explains that the accrue-in-advance method of accounting results in the recognition of liabilities that do not meet the definition of a liability in FASB Concepts Statement No. 6, *Elements of Financial Statements*, because it causes the recognition of a liability in a period prior to the occurrence of the transaction or event obligating the entity. The fact that an entity may incur future maintenance costs to improve the operating efficiency of an asset, comply with regulatory operating guidelines, or extend the useful life of the asset does not embody a present duty or responsibility of the entity prior to the obligating transaction or event. FASB distinguishes the recognition of a liability using the accrue-in-advance method from a liability for an asset retirement obligation in accordance with FASB Statement No. 143, *Accounting for Asset Retirement Obligations*, by stating that the liability required to be recorded for an asset retirement obligation is based on a legal obligation for which the event obligating the entity has occurred.

2.28 Although the FSP specifically addresses the accounting practices used by the airline industry, it states that the guidance in FSP AUG AIR-1 is applicable to all industries. For required disclosures and other information, refer to the full text of the FSP on the FASB Web site at www.fasb.org.

Chapter 3

Future Major Repairs and Replacements

3.01 One of a common interest realty association's (CIRA's) primary duties is to maintain and preserve the common property. Because the costs of maintaining and preserving common property are shared by all owners, it is the CIRA's duty to exercise careful planning for the funding of future major repairs and replacements. While CIRAs often fund these costs through contributions over the life of the components, CIRAs also fund the costs by assessing owners when funds are needed, or by borrowing. If a CIRA chooses to fund the costs over extended time periods, it reports assessments in the fund for major repairs and replacements.[1]

3.02 CIRAs may assess its members for future major repairs and replacements, as permitted by statute, association documents, lenders' requirements, or a decision of the board of directors supported by unit owners. Inadequate funding for future major repairs and replacements may adversely affect the ability of owners to sell or refinance their units, because of the concerns of prospective buyers, or because of the difficulty of obtaining mortgage financing under programs of various federal and quasi-federal lending-related organizations. In addition, a lack of funding can directly affect the CIRA's property values since the funds may not be available to provide for the necessary major repairs and replacements.

3.03 Before developing a funding policy for major repairs and replacements of common property, the board of directors ordinarily should review the governing documents, applicable state statutes as well as consider their fiduciary responsibility to adequately fund for these costs. The board has the following options, subject to such documents and statutes, in developing a policy:

a. Funding through periodic assessments over the estimated life of the common property

b. Funding through special assessments at the time a major repair or replacement of common property is needed

c. Borrowing

d. Although less common, seeking grants or other kinds of programs from governmental entities (for example, energy retrofits, and arbor plantings)

e. Although less common, seeking assistance from governmental agencies, for example if the association is geared to or established for low-moderate income homeowners, financial programs are sometimes available

f. A combination of these options

3.04 To implement a policy to accumulate funds for major repairs and replacements, a CIRA's board of directors often needs to educate owners about the

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[1] The fund is commonly referred to as a *reserve fund* in the legal documents of CIRAs and in the industry. The term *reserves* is not used in this guide because different meanings are attached to it, and misinterpretations could result.

benefits of accumulating such funds in advance through periodic assessments and to understand the benefits of a systematic accumulation of funds, including

a. having assurance that funds for major repairs and replacements will be available when needed.

b. development of an equitable method of charging current rather than future owners with the cost of the current use of assets.

c. preservation of the market value of individual units or shares.

d. compliance with the governing documents, statutes, mortgages, bonds, and the like.

3.05 Although this is not common, the documents of some CIRAs authorize their boards of directors to fund major repairs or replacements by levying special assessments when the money is needed. Often, the documents require that special assessments be approved by a vote of the unit owners. If a special assessment is not approved, the CIRA will not be able to fulfill its obligation to replace and repair the common property. In addition, because there may be uncertainties about the ability of some owners to pay large special assessments, the board may consider it preferable to fund in advance through periodic assessments. Above all, it is important that the boards of directors be aware that the primary goal of an assessment policy is to meet the fiduciary duties to maintain and preserve the common property.

3.06 In developing a plan,[2] the age and condition of the components of the common property are considered. The possibility that new types of material and equipment may be available may also be considered. The preparer[3] calculates a suggested annual funding amount and, in doing so, may consider such factors as which components to include, estimated replacement costs, useful lives, inflation, and interest or other earnings rates. Annual contributions to the replacement fund may be based on studies, such as engineering studies (more commonly known as a *reserve study*), developed to determine the timing and costs for future major repairs and replacements. A study generally includes the following:[4,5]

- Identification and analysis of each major component of common property
- Estimates of the remaining useful lives of the components
- Estimates of the costs of replacements or repairs

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[2] Although not used within this chapter, the term generally used within the industry for this plan is called a *reserve study*. The general requirements for a study of this type are presented within *The National Reserve Study Standards of the Community Associations Institute*, which is referenced in appendix D of this publication.

[3] The *Community Associations Institute* provides qualified preparers with a *Reserve Professionals Designation* (R.S.) upon confirmation of both educational background as well as minimum experience levels in the preparation of reserve studies. There is no requirement in this guide that reserve preparers be engineers; they can be board members, accountants, contractors, managing agents, and the like.

[4] The publication *National Reserve Study Standards of the Community Associations Institute* indicates that reserve studies include (1) a physical analysis and (2) a financial analysis. In addition, the study provides readers with, among other things, a description of the service levels offered as well as the types of funding plans available. Contact information for Community Associations Institute (CAI) appears in appendix D of this publication.

[5] A materiality threshold may need to be established.

- A cash flow projection showing anticipated changes in expenditures and contributions over a time period generally ranging between 20 and 30 years
- The *funding goal* (also known as the funding mechanism or plan), which is generally one of the following:
  - — Full funding, which is a goal of attaining and maintaining the cumulative cash balance at or near 100 percent funded
  - — Threshold funding, which is a goal of keeping the cash balance above a specified dollar or percent funded amount
  - — Baseline funding, which is a goal of keeping the cash balance in the account above zero
  - — Statutory funding, which is a goal of setting aside the specific minimum amount of reserves required by local statutes
- The *fund status*, generally measured in cash or as *percent funded* (*percent funded* is defined as the ratio of the actual or projected funds available for future major repairs and replacements to the fully funded balance, expressed as a percentage)
- The level of service used in the preparation of the study

3.07 Replacement information may also be obtained from contractors, suppliers, technical specialists (for example, with the widespread use of IT, cable, and fiber optics, typical contractors may not be sufficient), reserve study specialists or from using tables in technical manuals on useful lives of various components. It is useful for a CIRA board to reevaluate its funding level each year based upon changes to the common elements as well as changes to replacement costs and component conditions. The specific components of common property that a CIRA may decide to include in its funding plan depend on the kind of project, its construction, and the CIRA's applicable governing documents and state statutes. Such components are generally limited to those with a useful life of 30 to 40 years[6] or less from the time of the study preparation depending on the philosophy of the individual performing the reserve study. The components may include roofing, electrical systems, plumbing, IT equipment, floor coverings, seawalls, air conditioning systems, heating and hot water equipment, roads, recreational facilities, and furniture and equipment owned or maintained by the CIRA. Components for which there are maintenance contracts may not be included if the contracts provide for maintenance and replacement of the components. CIRAs also often include within their overall budget for future major repairs and replacements a deferred maintenance fund for those components requiring periodic maintenance that does not occur annually.[7] Typically, the deferred maintenance fund would include such components as painting, staining, and caulking.

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[6] Please note that some state statutes may not have a maximum age requirement or it may be different. Refer to those for further guidance.

[7] A comprehensive description of reserve studies can be found in the publication *Reserve Funds: How & Why Community Associations Invest Assets* published by the CAI, which is referenced in appendix D of this publication.

Reporting Considerations

3.08 CIRAs that assess owners annually for portions of future major repairs and replacements should report those assessed amounts separately from amounts assessed for normal operations. If a CIRA uses fund reporting, amounts assessed for future major repairs and replacements should be reported in the major repair and replacement fund separately from transactions in the operating fund. Transfers between funds that are not part of the current-period operating revenues should be presented only in a statement of changes in fund balances or in a statement of changes in members' equity, if a nonfund reporting approach is used. See paragraphs 4.27 and 4.33 of this guide for recommended disclosures.

Chapter 4

Financial Statement Presentation

General Method of Presentation

4.01 As discussed in chapter 1 of this guide, common interest realty associations (CIRAs) conduct and report on 2 primary kinds of activities: (*a*) the CIRA's normal maintenance and service operations, such as gardening, management, snow removal, minor repairs, and janitorial services, and (*b*) the CIRA's long term major repair and replacement requirements, such as roof replacements, street resurfacing, and painting. CIRAs usually assess their members for both purposes and generally should report such assessments separately. This guide recommends fund reporting because the AICPA Task Force on Accounting for Common Interest Realty Associations believes that it is the most informative method of presenting these separate activities.[1] Some CIRAs may also conduct commercial operations or separate business activities, such as rental operations, in addition to their primary activities. Such activities may be reported on as one or more additional funds. Total amounts of all fund groups should be reported for each financial statement presented.

4.02 Nonfund reporting is an alternative to fund reporting. The task force, however, believes that fund reporting is more informative to users, because financial statements using nonfund reporting often do not disclose whether assessments have been used for purposes other than those for which they were designated. For example, if nonfund reporting is used, a user of financial statements may be unable to determine whether assessments for future major repairs and replacements have been used in current operations.[2] A CIRA may not need to use fund reporting if it does not assess for future major repairs and replacements or if it has no special assessments, insurance proceeds, or settlement funds that are designated for specific purposes.

Method of Accounting

4.03 Generally accepted accounting principles (GAAP) requires the use of the accrual basis of accounting. Financial statements presented on an accrual basis are particularly useful for CIRAs, which assess members based on annual budgets, because they include information about amounts payable and assessments receivable from members and thus enable users to compare the results of operations to budgeted amounts.

4.04 If a CIRA prefers to present its financial statements on a cash basis, and the amounts differ materially from those in statements presented on an

[1] The discussion of fund reporting does not apply to the financial statements of cooperative housing corporations. However, a presentation using fund reporting may be more informative to users of the financial statements of cooperative housing corporations if a separate fund is maintained for future major repairs and replacements. Exhibits A-1–A-4 of appendix A illustrate the fund reporting approach.

[2] Because this guide primarily addresses the fund reporting approach, readers should substitute the term *members' equity* for the term *fund balance* if financial statements using nonfund reporting are presented. Furthermore, the fund for major repairs and replacements would be presented as an appropriation of retained earnings in such financial statements. Exhibit A-12 of appendix A illustrates that appropriation.

accrual basis, the financial statements are not in conformity with GAAP and are considered to be prepared on another comprehensive basis of accounting.[3]

Financial Statements

4.05 Full presentations of financial statements for CIRAs presented in conformity with GAAP should include the following:

- A balance sheet
- A statement of revenues and expenses
- A statement of changes in fund balances[4]
- A statement of cash flows
- Notes to financial statements

Balance Sheet

4.06 Information about the operating fund should present assets, liabilities, and the fund balance specifically associated with the CIRA's normal maintenance and service activities. For example, the operating fund should include information about cash, assessments receivable, prepaid expenses, and trade payables. Property and equipment, if reported as assets, are generally reported in the operating fund. If the amount of property and equipment held by a CIRA is significant, the CIRA may account for it in a separate fund.

4.07 The presentation of information about the fund for major repairs and replacements (referred to in the illustrative financial statements in appendix A as the *replacement fund*) should include information about assets, liabilities, and the fund balance specifically associated with the CIRA's long term major repair and replacement activities. The fund includes all assets that are held, for example, for the major repair and future replacement of roofs, roads, and furniture (some CIRAs may have a deferred maintenance fund which is utilized for painting or refinishing of building exteriors as discussed in paragraph 3.07). Those assets usually consist of cash, marketable securities, and short-term investments. Liabilities in that fund generally are for work done on contracts for major repairs and replacements. Financial Accounting Standards Board (FASB) Statement No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities—Including an amendment of FASB Statement No. 115*, discussed in chapter 2 of this guide, provides guidance on fair value measurements of financial assets and financial liabilities.

4.08 CIRAs may have interfund receivables and payables resulting from either of the following:

a. Obligations of one fund are paid for with the assets of another fund.

b. Amounts assessed for the activities of one fund are collected, but not transferred, by another fund.

Corresponding interfund receivables and payables should be presented to highlight the transactions resulting in those balances and to provide information

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[3] AU section 623, *Special Reports* (AICPA, *Professional Standards*, vol. 1), provides guidance on auditors' reports on financial statements prepared on a comprehensive basis of accounting other than generally accepted accounting principles.

[4] A statement of changes in members' equity if nonfund reporting is used.

about amounts assessed and collected that were not used in accordance with the budget.

4.09 Illustrations of transactions resulting in obligations of one fund being paid for with the assets of another fund include the following:

- Roof replacement, which is an expenditure of the replacement fund, paid for by the operating fund
- Insurance premiums, which are an expenditure of the operating fund, paid for by the replacement fund
- Interest income, which may be earned by one fund but then allocated by the board of directors to the operating fund

The following is an illustration of a transaction in which amounts assessed for the activities of one fund are collected, but not transferred, by another fund:

> A CIRA's budget includes an annual assessment of $80,000 for future major repairs and replacements, which is reported as revenue of the replacement fund. However, due to an unexpected increase in operating costs, the CIRA's board of directors transferred only $50,000 of the $80,000 to the replacement fund. Under these circumstances, the CIRA's financial statements should reflect $30,000 as a receivable from the operating fund and as a payable to the replacement fund. If the operating fund is unable to or does not intend to repay that amount or a portion of it to the replacement fund, a permanent transfer between the funds should be reported for the portion that will not be repaid. Recording a permanent transfer for amounts previously recorded as an interfund receivable or payable results in a corresponding reduction of the existing interfund receivable or payable. Exhibits A-2 and A-3 and note 4 of exhibit A-5 of appendix A illustrate that presentation.

4.10 CIRAs can generally present unclassified balance sheets. CIRAs having significant commercial operations, however, should consider presenting classified balance sheets.

4.11 The difference between the assets and the liabilities of each fund group should be presented as the fund balance of the respective fund group. Changes in those balances should be presented in a statement of changes in fund balances. Additional analysis of fund balances, although not required, may be presented in the notes to the financial statements or schedules. Exhibit A-7 of appendix A provides an illustration.

Deferred Revenue

4.12 Deferred revenue may include items such as special assessments designated for specific costs that have not yet been incurred. Such amounts should be reported as revenues when the corresponding liabilities and expenses are reported.

Statement of Revenues and Expenses

4.13 The statement of revenues and expenses should present information about all assessments, other revenues, and expenses. All CIRA activities, except for replacement fund activities, should be presented in the operating fund in the statement of revenues and expenses unless the CIRA has other funds such as deferred maintenance fund or capital improvement fund. Depreciation should be reported as an expense of the fund in which the asset is reported. Periodic assessments for funding future major repairs and replacements should be reported in the replacement fund in statements of revenues and expenses in the periods in which they are assessed, regardless of whether they have been collected or expended.

4.14 Information about revenues should include amounts for regular and special assessments from members and amounts for such items as assessments charged to the developer, developer contributions and subsidies, lawsuit settlements, interest income, laundry and vending machine income, or special-use charges from members and nonmembers. Individual categories of revenues may be combined if not material. Interest earned should be presented as revenue of the appropriate fund unless the CIRA has a specific policy to treat it otherwise.

4.15 Special assessments should be reported as revenue, unless they are deferred in accordance with the guidance in paragraph 4.12 of this guide.

4.16 Because income taxes are generally not related to the excess of revenues over expenses as in commercial entities, they may be presented in the same manner as other operating expenses. CIRAs should follow the guidance in FASB Statement No. 109, *Accounting for Income Taxes* and its related interpretation, FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes—an interpretation of FASB Statement No. 109*, including its related FASB Staff Positions (FSPs).

Statement of Changes in Fund Balances

4.17 The financial statements should include a statement of changes in fund balances, which reconciles beginning and ending fund balances with results of operations for the period. The statement may be presented separately or may be combined with the statement of revenues and expenses. Permanent transfers between funds should be presented as interfund transfers in the statement of changes in fund balances, not as revenues (see exhibit A-2 of appendix A). For example, if the board of directors transfers excess operating funds to the replacement fund at the end of an operating year, the interfund transfer should be shown in the statement of changes in fund balances, not by reclassifying revenues.

Statement of Cash Flows

4.18 A CIRA should present a statement of cash flows when it presents a balance sheet and statement of revenues and expenses. The statement may be presented using the direct method or the indirect method. The direct method begins with the total revenue that provided cash during the period and deducts the costs and expenses that required the payment of cash during the period. Exhibit A-3 of appendix A illustrates the direct method using a fund approach. Exhibit A-11 of appendix A illustrates the direct method using a nonfund approach. The indirect method begins with an excess of revenues over expenses, or of expenses over revenues, and is adjusted for items not requiring cash. Exhibit A-4 of appendix A illustrates the indirect method.

Comparative Financial Statements

4.19 GAAP does not require comparative financial statements. Nonetheless, Accounting Research Bulletin No. 43, *Restatement and Revision of Accounting Research Bulletins*, chapter 2A, "Comparative Financial Statements," states that "the presentation of comparative financial statements in annual and other reports enhances the usefulness of such reports and brings out more clearly the nature and trends of current changes affecting the enterprise." Because of space limitations and to avoid cumbersome or confusing formats, some CIRAs present total-of-all-funds information for the prior period rather than information by individual funds. A continuing auditor need not report on the prior period financial statements if only summarized comparative information of the prior period is presented. Nonetheless, in some circumstances the client may request the auditor to express an opinion on the prior period as well as the current period. In those circumstances, the auditor should evaluate whether the information included for the prior period contains sufficient detail to constitute a fair presentation in conformity with GAAP. Exhibits A-1, A-2, and A-4 of appendix A illustrate comparative financial statements using a multicolumn format for the current period and a single total-of-all-funds column for the prior period.

Accompanying Information[5]

4.20 A CIRA's records usually contain more details than are necessary to present financial statements in conformity with GAAP. Consequently, the financial statements may include accompanying information that is not required but may be meaningful to users. Accompanying schedules that compare details of the CIRA's expenses with budgeted amounts provide users with additional information that is helpful in evaluating the performance of the CIRA's board and management team. For example, although CIRAs budget and account separately for costs of insurance for property, liability, and directors' liability insurance, expenses may be presented as a single line item in the financial statements. An accompanying schedule presenting insurance expenses by classification with comparative budget information provides more detailed information. Further schedules comparing budgeted amounts with actual expenses for all accounts and reconciling them to the financial statements may be helpful to users.

4.21 Although not required by GAAP, a CIRA's financial statements may be accompanied by a schedule analyzing the CIRA's program for major repairs and replacements. That schedule may present beginning balances, additions, expenditures, and ending balances of funds for future major repairs and replacements by individual categories of common property. Exhibit A-7 of appendix A illustrates that.

Note Disclosures

4.22 In addition to disclosures required by GAAP for other entities, the notes to a CIRA's financial statements should also include disclosures about

- the CIRA's legal form (corporation or association) and that of the entity for which it provides services (for example, condominium,

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[5] Statement on Standards for Accounting and Review Services (SSARS) No. 13, *Compilation of Specified Elements, Accounts, or Items of a Financial Statement* (AICPA, *Professional Standards*, vol. 2, AR sec. 110), expands SSARS to apply when an accountant is engaged to compile or issues a compilation report on one or more specified elements, accounts, or items of a financial statement thereby allowing practitioners to be more responsive to the needs of their clients and users of financial statements. An illustrative example of an engagement letter can be found at paragraph .15 of AR section 110.

homeowner's association, or cooperative), areas it controls, and the number of units. (In place of the number of units, cooperative housing corporations may disclose the number of shares and time-share associations may disclose the number of weeks.)

- common property, as discussed in paragraph 2.23.
- services (such as maintenance) and subsidies provided by the developer.
- the CIRA's income tax filing status and its liability for income taxes.
- the proposed use for funds collected in special assessments.
- the number of units (shares for cooperative housing corporations and weeks for time-share associations) owned by the developer.
- credits from taxing authorities that will be phased out in future reporting periods.
- assessments that were used for purposes other than those for which they were designated.
- funding for future major repairs and replacements, as discussed in paragraph 4.27 of this guide.

4.23 In conformity with AICPA Statement of Position (SOP) 94-6, *Disclosure of Certain Significant Risks and Uncertainties* (AICPA, *Technical Practice Aids*, ACC sec. 10,640), CIRAs should include in their financial statements disclosures about the nature of their operations and about the use of estimates in the preparation of financial statements. In addition, if specified disclosure criteria are met, CIRAs should include in their financial statements disclosures about certain significant estimates and about current vulnerability due to certain concentrations, such as cash in the same bank which exceeds FDIC limits. FSP 94–6–1, *Terms of Loan Products That May Give Rise to a Concentration of Credit Risk*, clarifies the circumstances in which terms of loan products would give rise to a concentration of credit risk as that term is used in FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments*. An example may include a loan whose terms require the borrower to increase the repayment amounts at certain intervals which could affect a borrower's ability to repay the loan and lead to increased defaults and losses. Judgment is required to determine whether loan products have terms that give rise to a concentration of credit risk. This FSP reminds readers to consider other accounting literature in addition to SOP 94-6 including, but not limited to, FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, and FASB Statement No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases*.

Related Parties

4.24 Some individual board members, officers, developers, or management companies may provide CIRAs with insurance, maintenance, management, or other services. Such services may require disclosure in conformity with FASB

Statement No. 57, *Related Party Disclosures*. This statement also defines related parties.

Significant Sources of Revenue

4.25 The developer or other parties may provide the CIRA with some of its revenues. If 10 percent or more of a CIRA's revenues are derived from any one source, that fact and the amount of revenue from each source should be disclosed.

Common Property

4.26 Paragraph 2.23 of this guide provides guidance to CIRAs on the disclosure of certain information concerning common property in the notes to their financial statements.

The following note X illustrates disclosure in the notes to the financial statements of a CIRA, ABC Homeowners' Association, Inc., given the following facts.

Property

The CIRA holds title to common property consisting of the following:

(*a*) A property that contains a golf course on 200 acres and a restaurant, on 2 acres. This property is used to generate significant cash flows from members on the basis of usage and from nonmembers.

(*b*) Other common real property consisting of sidewalks, roads, and greenbelts on 20 acres; a clubhouse on 2 acres; and partially developed land on 5 acres that is the future site of a swimming pool expected to be built in 20X9. This common property

(1) is *not* used to generate significant cash flows from members on the basis of usage or from nonmembers.

(2) cannot be sold and the proceeds cannot be retained by the CIRA.

(*c*) Common personal property consisting of equipment.

The disposition and use of some of that property is restricted by the CIRA's governing documents.

Accounting Policy

The CIRA's policy for recognizing common property as assets in its balance sheet is to recognize (*a*) common personal property and (*b*) real property to which it has title and that it can dispose of for cash while retaining the proceeds or that is used to generate significant cash flows from members on the basis of usage or from nonmembers. Therefore, the CIRA recognizes as assets the golf course (design fees and land improvements), restaurant, land on which the golf course and restaurant were built, and the equipment.

Note X. Common Property

Major classifications of property and equipment and their respective lives are summarized in the following table:

	December 31		Depreciable Life
	20X7	20X6	
Land related to the golf course and the restaurant	$3,030,000	$3,030,000	
Golf course	1,000,000	1,000,000	
Restaurant	160,000	160,000	25 years
Equipment	25,000	20,000	5 years
	4,215,000	4,210,000	
Accumulated depreciation	21,800	10,400	
Net property and equipment	$4,193,200	$4,199,600	

Depreciation expense is computed on the straight-line basis for financial reporting purposes and was $11,400 and $10,400 for the years ended December 31, 20X7 and 20X6, respectively.

On December 31, 20X7 and 20X6, the association held title to common real property consisting of a golf course on 200 acres of land, sidewalks, roads, and greenbelts on 20 acres of land, a clubhouse on 2 acres of land, a restaurant on 2 acres of land, and 5 acres of partially developed land that is the future site of a swimming pool expected to be built in 20X9. The association is responsible for preserving and maintaining the properties and may dispose of them only with the unanimous consent of the unit owners, with all proceeds from the disposition remitted to the unit owners. In conformity with industry practice, the association recognizes the following common property as assets:

(a) Common personal property

(b) Common real property to which it has title and that it can dispose of for cash while retaining the proceeds or that is used to generate significant cash flows from members on the basis of usage or from nonmembers

Accordingly, the association recognized the acquisition of the restaurant, the golf course, and the land on which they are built as assets at their fair values on December 31, 20X4, the date on which they were transferred from the developer. Other common property, primarily consisting of sidewalks, roadways, and greenbelts; a clubhouse on 2 acres of land; and 5 acres of partially developed land that is the future site of a swimming pool expected to be built in 20X9 is not recognized assets.

Future Major Repairs and Replacements

4.27 A CIRA should disclose information in its financial statements about its funding for future major repairs and replacements. Disclosures about such funding should include the following:

- Requirements, if any, in statutes or the CIRA's documents or mortgage or governmental bodies funding requirements (for example, the Federal Housing Administration often has such requirements) to accumulate funds for future major repairs and replacements and the CIRA's compliance or lack of compliance with them

- A description of the CIRA's funding policy, if any, and compliance with that policy
- A statement that funds, if any, are being accumulated based on estimated future (or current) costs, that actual expenditures may vary from these estimates, and that the variations may be material
- Amounts assessed for major repairs and replacements in the current period, if any
- A statement indicating whether a study was conducted to estimate the remaining useful lives of common property components and the costs of future major repairs and replacements

CIRAs that fund future major repairs and replacements by special assessments or borrowings when needs occur should disclose that information.

4.28 If the disclosure about a CIRA's funding for major repairs and replacements required by paragraph 4.27 of this guide is absent or inadequate, the auditor should express a qualified or adverse opinion because of the departure from GAAP and should provide the information in the report, if practicable, as provided in paragraph .41 of AU section 508, *Reports on Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1).

4.29 Note 4 of exhibit A-5 in appendix A, alternative B, illustrates disclosure about a study that was conducted by a consultant to estimate expenditures for major repairs and replacements and the recommendations of which were adopted by the board of directors. The following illustrate disclosures that may be used in other circumstances:

- The CIRA elects to only partially adopt the study's recommendations.

Disclosure

The disclosure would be the same as that in note 4 of exhibit A-5 of appendix A, alternative B, but the next-to-the-last paragraph and the paragraph preceding it would be replaced by the following:

The board of directors has decided to fund in 20X8 only 50 percent of the amount recommended by the study. Accordingly, $149,000 has been included in the 20X8 budget. For that reason, and because actual expenditures may vary from estimated future expenditures and the variations may be material, amounts accumulated in the replacement fund may not be adequate to meet all future needs for major repairs and replacements. If additional funds are needed, the association has the right, subject to membership approval, to increase regular assessments, pass special assessments, or delay major repairs and replacements until funds are available.

- The board of directors has conducted a study to estimate future expenditures for major repairs and replacements. Unit owners have decided not to fund those needs currently.

Disclosure

The disclosure would be the same as in note 4 of exhibit A-5 of appendix A, alternative A, but the next-to-the-last paragraph and the paragraph preceding it would be replaced by the following:

The funding program was included in the proposed budget for 20X8, which was presented to unit owners at a general meeting on December 1, 20X7. At that meeting, a majority of owners voted not to include funding for major repairs and replacements in the annual budget for 20X8. For that reason, and because actual expenditures may vary from estimated future expenditures and the variations may be material, amounts accumulated in the replacement fund may not be adequate to meet all future needs for major repairs and replacements. When funds are needed for those purposes, the association has the right, subject to membership approval, to increase the regular assessments, pass special assessments, or delay major repairs and replacements until funds are available.

4.30 The following illustrates disclosure in the financial statements of an association that has not conducted a study to estimate the remaining useful lives and the costs of future major repairs and replacements of the common property that will be required in the future.

Disclosure

Note 4 of exhibit A-5 of appendix A might be stated as follows:

The association has not conducted a study to determine the remaining useful lives of the components of common property and current estimates of costs of major repairs and replacements that may be required in the future. The board has also not developed a plan to fund those needs. When replacement funds are needed to meet future needs for major repairs and replacements, the association has the right to increase regular assessments, pass special assessments, or delay major repairs and replacements until funds are available. The effect on future assessments has not been determined at this time.

4.31 Although this is not a requirement of the guide, CIRAs may also consider disclosing the type of funding plan goal that was used in the reserve study so the readers of the financial statements are able to understand the implications of the method chosen to make informed and educated decisions. The 3 types of nonstatutory funding plans are full funding, threshold funding and baseline funding. Depending on the method used, there could be significant fluctuations in assessment levels. When the threshold method is used, the CIRA may also consider disclosing the threshold level dollar amount that is being utilized. If averaging techniques are used, CIRAs may consider disclosing that fact as well. Whatever method is used, the CIRA may also consider disclosing the fund status or percent funded discussed in chapter 3 of this guide.

4.32 Another disclosure that also is not a requirement of the guide that may be considered by the CIRA is the disclosure of the level of service used to perform the reserve study. The National Reserve Study Standards include 3 levels of service, which are (1) Full, (2) Update, with site-visit and on-site review, and (3) Update, with no site-visit or off-site review. Disclosure will let the reader know what level of service was performed because they vary greatly in detail.

Required Supplementary Information

4.33 CIRAs should present the following as unaudited supplementary information:

- Estimates of current or future costs of future major repairs and replacements of all existing components, such as roofs, including estimated amounts required, methods used to determine the costs, the basis for calculations (including assumptions, if any, about interest and inflation rates), sources used, and the dates of studies, made for this purpose, if any.[6]
- A presentation of components to be repaired and replaced, estimates of the remaining useful lives of those components, estimates of current or future replacement costs, and amounts of funds accumulated for each to the extent designated by the board.

4.34 Exhibit A-8 of appendix A, alternative A, illustrates unaudited supplementary presentation based on a study conducted by the board of directors about the estimates of current costs of major repairs and replacements. Alternative B illustrates unaudited supplementary presentation based on a study conducted by a consulting firm about the estimates of future costs of major repairs and replacements. Paragraph 7.123 of this guide illustrates an additional explanatory paragraph that would be added to the auditor's report if that information is not presented. Paragraphs 7.124–.126 of this guide illustrate additional explanatory paragraphs that would be added to the auditor's report in the event any of the following situations occurred:

- That information materially departs from information required in paragraph 4.33 of this guide.
- The procedures prescribed in paragraph 7.101 of this guide were not completed.
- The auditor has unresolved doubts about the adherence of the information to the information required in paragraph 4.33 of this guide.

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[6] There is no requirement for CIRAs to obtain studies prepared by professional engineers. The estimates may be made by the board of directors or estimates obtained from licensed contractors, as discussed in paragraph 3.07 of this guide.

Chapter 5

Budgets

5.01 Budget information is not a required part of the basic financial statements. If presented, that information should be identified as supplementary and clearly marked as not covered by the independent auditor's report.

5.02 The legal documents creating most common interest realty associations (CIRAs) require that assessments be based on budgets. The budgets of CIRAs are the monetary expression of their goals and objectives and emphasize the stewardship responsibility of their boards of directors. According to Financial Accounting Standards Board Statement of Financial Accounting Concepts No. 4, *Objectives of Financial Reporting by Non-Business Organizations*, budgets are used to allocate and control the use of resources. Budgets are also used to obtain resources. For example, budgets are pivotal in establishing levels of dues, taxes, and fees to be imposed.

5.03 The boards of directors of CIRAs use the budgeting process to determine the required assessments from owners to fund current services and to provide for future major repairs and replacements and deferred maintenance needs. Unit owners use budgets to evaluate the performance of boards of directors. Other users, such as creditors, realtors, and potential buyers, may use budgets to compare CIRAs with other CIRAs and to monitor the ability of CIRAs to provide acceptable levels of service.

The Budget Process

5.04 A CIRA's board of directors or governing body establishes the budget. The budget's effectiveness depends on the board's willingness to take prompt corrective action on unfavorable variations from the budget. In developing the budget, the board establishes standards and levels of service for the CIRA, which may involve using outside management firms, polling the CIRA's owners through surveys or public hearings, and relying on the reports and plans of various board committees. The budget process includes the following:

- A review of the CIRA's documents, board minutes, and statutory requirements
- A comparison of historical financial statements with related budgets
- A review of existing contracts and contracts in place for future services
- The development of specifications to solicit bids from outside contractors
- Consultation with public utilities to estimate future rates
- Line-by-line analysis of current expenses and consideration of proposed changes and alternatives
- Integration of special programs that may overlap the current budget cycle
- Identification of seasonal and monthly variations
- Forecasts of operating results for the balance of the current year and for the next fiscal year

Other major factors that may be considered in the budget process are the level of deterioration of major common property components, the need for a provision for contingencies, evaluation of outside contractors responding to bid requests, and evaluation of applicable building codes and ordinances. Ongoing budget reviews help refine estimates and spread the budget-preparation workload throughout the year.

Format and Components of a Budget

5.05 It is useful to present budgets in a format that is consistent with the financial statements of CIRAs and comparable with prior periods. Budget presentations vary widely and many include descriptions of various line items and formulas to compute certain expenses, individual fees, or assessment calculations. Although such additional information is useful, its inclusion in the basic budget documents may confuse readers.

Operations

5.06 A budget's provision for operations includes amounts for the CIRA's routine operating expenses, such as management fees, utilities, staff payroll, insurance, rubbish removal, routine maintenance of common property, and certain minor additions to common property.

Future Major Repairs and Replacements

5.07 A budget's provision for future major repairs and replacements includes amounts for repairs or replacements of major components of common property, such as roofs, parking areas, elevators, and swimming pools, and for painting. Budgeting for future major repairs and replacements involves establishing amounts of assessments needed to fund anticipated expenditures as well as amounts necessary to fund major repairs or replacements required during the current period. The noncurrent element of this portion of the budget would ideally be part of a plan spanning the present and future periods.

Other Expenditures

5.08 Provisions for other expenditures include amounts for significant nonrecurring expenditures or income-tax-related items that cannot be classified as operating or major repair and replacement activities, for example, capital additions, nonrecurring major expenditures such as legal fees or construction-related items, and replacements for which there are no other provisions. Such expenditures may be funded by CIRAs through special assessments or borrowings.

Presentation of Budget Information in Financial Statements

5.09 CIRAs that present interim financial statements commonly include comparisons with the budget to determine areas that may warrant management's action. Budget compliance is particularly significant for CIRAs because users of their financial statements compare budgeted to actual amounts to evaluate the board's fiscal responsibility. Despite the helpfulness of such comparisons, budget information is not always presented in the annual reports of CIRAs, although such reports often may be the only financial information about the operations of CIRAs available to owners and other users.

Chapter 6

Income Tax Considerations[1]

6.01 All common interest realty associations (CIRAs) are required to file federal, and possibly state and local, income tax returns, and they may be required to pay income taxes. The tax life of a CIRA begins on the earlier of the date of incorporation or the date it begins business operations as a corporation or as an unincorporated association taxable as a corporation. A review of a CIRA's legal documents usually reveals that date.

Methods of Filing

6.02 As a general rule, CIRAs annually file income tax returns using Federal Form 1120 (U.S. Corporation Income Tax Return) except for cooperative housing corporations, which file Form 1120-C or, if the association qualifies as a residential homeowners association under Internal Revenue Code (IRC) section 528, it may annually elect to file Federal Form 1120-H (U.S. Income Tax Return for Homeowners Associations). CIRAs that are exempt under IRC section 501 must file Federal Form 990 (Return of Organizations Exempt from Income Tax). The filing method selected depends on the CIRA's circumstances and its available income-tax-planning alternatives. Effective for tax years ending on or after December 31, 2007, cooperative housing corporations must file their annual income tax returns using Federal Form 1120-C (U.S. Income Tax Return for Cooperative Associations) under IRC section 1381.

Federal Forms 1120 and 1120–C

6.03 CIRAs filing Federal Form 1120 and cooperative housing corporations filing Form 1120-C are taxed, in general, as regular corporations. However, IRC section 277 (only as it applies to CIRAs filing Form 1120) requires nonexempt membership organizations, other than cooperative housing corporations that file under subchapter T of the code, to separate income and expenses into membership and nonmembership activities. Under IRC section 277, certain CIRAs are generally taxed on both net membership and net nonmembership income. IRS Revenue Ruling 70-604 (see paragraph 6.10) provides an election, however, such that net membership income can be excluded from taxation. If the election is made, the excess of membership assessments over expenditures, if actually or constructively refunded to members or applied to the following year's assessments, is not taxable income. A CIRA's taxable income on form 1120 is subject to income taxes at the graduated corporate rates. Under IRC section 1381, cooperatives are generally taxed on both net patronage and net nonpatronage income. Paragraphs 9.18–.19 of this guide discuss patronage and nonpatronage income in greater detail.

6.04 The following specific issues may affect a CIRA (other than a housing cooperative) that elects to file as a regular corporation on Form 1120. IRC section 277(a) provides that a nonexempt membership organization operated

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[1] This chapter should not be considered to be a detailed explanation of the Internal Revenue Code (IRC) and rulings issued by the IRS as they apply to common interest realty associations (CIRAs). Its purpose is to inform auditors about several areas of federal income taxation they need to know to audit the tax provision and to be aware of noncompliance with tax laws.

primarily to furnish services or goods to members may deduct expenses attributable to providing its members with services, insurance, goods, or other items of value only to the extent of income derived during the year from members or transactions with members. The excess of deductions over such income in any taxable year is available as an unlimited carryover and is added to deductions for such amounts paid or incurred in succeeding taxable years for services, insurance, goods, or other items of value provided to members. Deductions covered by IRC sections 243, 244, and 245, which relate to dividends received by corporations, are not allowed for organizations to which IRC section 277 applies for the taxable year.

Federal Form 1120H

6.05 CIRAs that qualify as homeowners associations may elect to be taxed under IRC section 528 utilizing Form 1120-H. Qualifying CIRAs are taxed at a 30 percent flat rate (32 percent for timeshare associations)[2] on income in excess of $100, generally from sources other than membership dues, fees, and assessments. Net operating loss and dividends received deductions are not permitted.

The following benefits are often associated with an election to file under section IRC section 528:

- Income from member assessments is generally exempt from tax.
- An election to file under section IRC section 528 does not jeopardize the tax treatment applicable to individual unit owners.
- CIRAs that qualify and elect to file under IRC section 528 need not segregate amounts collected in advance for replacements and deferred maintenance, because members' assessments are tax exempt. (Contributions to capital retain their character, regardless of the election.)

Filing under IRC section 528 involves the following disadvantages:

- A CIRA's taxable income in excess of $100 is taxed at a flat 30 percent rate (32 percent for time-share associations), preventing its use of the benefits of the lower income tax brackets associated with regular corporate entities.
- Per use fees paid by members are membership income under IRC section 277 while they are generally taxable under IRC section 528.
- CIRAs filing under IRC section 528 may not use net operating loss deductions. An association may not revoke its section 528 elections made in previous years to obtain the tax benefits of a net operating loss carryback.[3]
- A CIRA filing under IRC section 528 is not entitled to use the alternative tax rate imposed by IRC section 1201(a).

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[2] The Taxpayer Relief Act of 1997 (PL 105-34) extended IRC section 528 taxation rules to timeshare associations.

[3] The IRS, however, has ruled that a CIRA may revoke its section 528 election if a professional tax adviser had provided inadequate advice on the benefits of the election.

Federal Form 990

6.06 CIRAs that file Federal Form 990 do so because they are exempt under IRC sections 501(c)(4), 501(c)(7), or 501(c)(12). Few CIRAs meet the eligibility requirements of IRC section 501(c). For those CIRA's that are granted exempt status, an annual review of the CIRA's continuing eligibility for exempt status is a good practice. If a section 501(c) exemption no longer applies, the CIRA is required to file Form 1120 or 1120-H.

Specific Areas for Review

Basis for Contributed Property

6.07 A significant question to be considered is whether a CIRA is entitled to receive an adjusted basis in property contributed to it by its developer. If property is contributed to a corporate entity under IRC section 351 on formation of the CIRA, the basis of the property in the corporation's hands is determined under IRC section 362.

6.08 IRC section 362 also applies to property acquired by a corporation as paid-in surplus or as a capital contribution under IRC section 118. A CIRA may receive a basis in property that is at least equal to the contributor's basis in the property before the contribution plus the amount of gain, if any, recognized by the contributor on the exchange.

Developer Settlements

6.09 Private Letter Ruling 8004028, issued by the IRS in September 1980, indicates that settlement proceeds received by a CIRA as a result of a class action suit against a developer are not includable in a CIRA's gross income. Revenue Ruling 81-152 states that, providing certain conditions are met, settlements represent recoveries of capital that reduce the bases of individual unit owners.

Recognition of Receipts as Current Revenue Versus Capital Contributions

6.10 The following IRS revenue rulings provide guidance on the appropriate treatment of assessments collected by the CIRA:

- *70-604*. Assessments by a *condominium management corporation* that are in excess of the amounts used for the operation of the condominium property, and that are returned to the owner-stockholders, or applied to the following year's assessments, are not taxable income to the operation. This exclusion is available only if the *CIRAs members* make a valid election to return the excess amounts or apply them to the following year's assessments.
- *74-563*. A special assessment collected by an *incorporated homeowner's association* from its members and set aside in a special bank account for paving a community parking area constitutes a contribution to the capital of the nonexempt association under IRC section 118.
- *75-370*. Special assessments collected by a *nonexempt condominium management corporation* from its *unit owner-stockholders* and accumulated in a separate bank account for replacement of the

roof and elevators in the condominium are not includable in the corporation's gross income. Revenue Ruling 75-370 does not apply to funds collected by a condominium for services such as maintenance of common elements, including painting, repairs, gardening, janitorial services, and so forth.

- *75-371*. Special assessments for the replacement of personal property, collected by a *nonexempt condominium management corporation* from its unit owner-stockholders and accumulated in a separate bank account, are contributions to capital. Revenue Ruling 75-371 indicates that contingency reserves are includable in the entity's gross income.

Chapter 7

Audit Considerations

Scope of This Chapter

7.01 Paragraph .01 of AU section 150, *Generally Accepted Auditing Standards* (AICPA, *Professional Standards*, vol. 1), states that an independent auditor plans, conducts, and reports the results of an audit in accordance with generally accepted auditing standards (GAAS). Auditing standards provide a measure of audit quality and the objectives to be achieved in an audit. This chapter includes guidance on the application of the standards of fieldwork and, more specifically, on the risk assessment process (which includes, among other things, obtaining an understanding of the entity and its environment, including its internal control). This chapter also provides guidance on other general auditing considerations related to common interest realty associations (CIRAs).

7.02 GAAS applies to audits of the financial statements of CIRAs in the same manner as they do to audits of other financial statements for other businesses. This section is not intended to mandate auditing procedures to be applied in every audit of a CIRA. Nor is the discussion of management's responsibility for internal control intended to prescribe the types of controls to be implemented in all circumstances.

Planning and Other Auditing Considerations

7.03 The objective of an audit of the financial statements of a CIRA is to express an opinion on whether its financial statements are presented fairly, in all material respects, and in conformity with generally accepted accounting principles (GAAP) or an other comprehensive basis of accounting. To accomplish that objective, the independent auditor's responsibility is to plan and perform the audit to obtain reasonable assurance (a high, but not absolute, level of assurance) that material misstatements, whether caused by errors or fraud, are detected. This section addresses general planning considerations and other auditing considerations relevant to CIRAs. Auditors are reminded that CIRA engagements may also involve a third party for those CIRAs that contract with association management companies, as discussed in chapter 1.

Audit Planning

7.04 The first standard of field work states the auditor must adequately plan the work and must properly supervise any assistants. AU section 311, *Planning and Supervision* (AICPA, *Professional Standards*, vol. 1), establishes requirements and provides guidance on the considerations and activities applicable to planning and supervision of an audit conducted in accordance with GAAS, including appointment of the independent auditor; preliminary engagement activities; establishing an understanding with the client; preparing a detailed, written audit plan; determining the extent of involvement of professionals with specialized skills; and communicating with those charged with governance and management. Audit planning also involves developing an overall audit strategy for the expected conduct, organization, and staffing of the audit. The nature, timing, and extent of planning vary with the size and complexity of the entity, and with the auditor's experience with, and understanding of, the entity and its environment, including its internal control.

7.05 Paragraph .03 of AU section 311 states that the auditor must plan the audit so that it is responsive to the assessment of the risks of material misstatement based on the auditor's understanding of the entity and its environment, including its internal control. Planning is not a discrete phase of the audit, but rather an iterative process that begins with engagement acceptance and continues throughout the audit as the auditor performs audit procedures and accumulates sufficient appropriate audit evidence to support the audit opinion.

Establishing an Understanding of the Engagement

7.06 Paragraph .08 of AU section 311 states the auditor should establish an understanding with the entity regarding the services to be performed for each engagement. This understanding should be documented through a written communication with the CIRA in the form of an engagement letter. Footnote 4 in paragraph .08 of AU section 311 provides guidance regarding with whom the auditor establishes such an understanding. The understanding should include

- the objectives of the engagement.
- management's responsibilities (either the association's internal management or external association management company).
- the auditor's responsibilities.
- the limitations of the engagement.

Included in the list of specific matters identified in paragraph .09 of AU section 311 that should be communicated in the form of an engagement letter regarding an audit of the financial statements is the notification that management is responsible for adjusting the financial statements to correct material misstatements. Paragraph .10 of AU section 311 names other matters that the understanding may include. A letter establishing such an understanding with respect to audit services is illustrated in exhibit B-1 of appendix B.

Independence

7.07 Paragraph .11 of AU section 311 states at the beginning of an audit engagement, in addition to performing other procedures, auditors should evaluate their compliance with ethical requirements, including independence. A member of the AICPA who is engaged to audit a CIRA in accordance with GAAS must be independent. ET section 101, *Independence* (AICPA, *Professional Standards*, vol. 2), its interpretations, and the Ethics Rulings under it set forth the requirements relevant to the auditor when making a judgment about whether he or she is independent.[1] A member may also seek advice from the AICPA's Professional Ethics Division on the application of interpretations and rulings to specific situations. Ethics Ruling No. 31, "Performance of Services for Common Interest Realty Associations (CIRAs), Including Cooperatives, Condominium Associations, Planned Unit Developments, Homeowners Associations, and Timeshare

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[1] Ethics Ruling No. 31, "Performance of Services for Common Interest Realty Associations (CIRAs), Including Cooperatives, Condominium Associations, Planned Unit Developments, Homeowners Associations, and Timeshare Developments," of ET section 191, *Ethics Rulings on Independence, Integrity, and Objectivity* (AICPA, *Professional Standards*, vol. 2, ET sec. 191 par. .061–.062), states that, with respect to an engagement to perform services for a CIRA, a *covered* member's independence would be considered to be impaired if the member is also a member of the CIRA as a result of ownership or lease of real estate, unless certain conditions are met.

Developments" of ET section 191, *Ethics Rulings on Independence, Integrity, and Objectivity* (AICPA, *Professional Standards*, vol. 2, ET sec. 191 par. .061–.062), sets forth additional guidance relevant to auditors of CIRAs that are also members of the CIRA.

7.08 Ethics Interpretation 101-3, "Performance of Nonattest Services" under Ethics Rule 101 (AICPA, *Professional Standards*, vol. 2, ET sec. 101 par. .05), sets forth requirements that apply when nonattest services are provided to attest clients. December 2003 revisions to the interpretation clarified existing guidance with respect to bookkeeping and internal audit services; placed further restrictions on services the auditor may perform with regard to valuation, appraisal, and actuarial services; and information systems design and development, and strengthened the general requirements of Ethics Interpretation 101-3 by requiring that an AICPA member document his or her understanding with the client regarding the services to be performed. These revisions as well as subsequent revisions adopted in January 2005 also reinforce the long-standing AICPA position that the member's attest client must designate an individual who possesses suitable skill, knowledge or experience or both, to oversee nonattest services provided by the member, including making all management decisions related to the services. The Professional Ethics Division maintains online resources to assist practitioners in understanding and applying the provisions of this interpretation at www.aicpa.org/Professional+Resources/Professional+Ethics+Code+of+Professional+Conduct/Professional+Ethics/Resources+and+Tools/.

Auditor's Communication With Those Charged With Governance

7.09 AU section 380, *The Auditor's Communication with Those Charged with Governance* (AICPA, *Professional Standards*, vol. 1), provides a framework for effective two-way communication between the auditor and those charged with governance, and identifies certain specific matters that the auditor must communicate to those charged with governance. For purposes of AU section 380, *those charged with governance* means the person(s) with responsibility for overseeing the strategic direction of the entity and obligations related to the accountability of the entity. This includes overseeing the financial reporting process. For entities that have a board of directors, as CIRAs typically do, the term *those charged with governance* encompasses the term *board of directors* used elsewhere in GAAS.

7.10 Note that AU section 380 does not establish requirements regarding the auditor's communication with an entity's management or owners unless they are also charged with a governance role. In some cases, all of those charged with governance are also involved in managing the entity. Matters communicated in accordance with AU section 380 to person(s) with management responsibilities need not be communicated again with those same person(s) in their governance role. Paragraph .22 of AU section 380 provides that, when all of those charged with governance are involved in managing the entity, the auditor should consider whether communication with person(s) with financial reporting responsibilities adequately informs all of those with whom the auditor would otherwise communicate in their governance capacity. Paragraph .18 of AU section 380 presents matters the auditor may consider in determining whether communication with subgroups of those charged with governance adequately fulfills the auditor's responsibility under this professional standard.

7.11 As provided in paragraph .49 of AU section 380, matters that may contribute to effective 2-way communication include discussion of the purpose of communications, the form in which communications will be made, the person(s) on the audit team and among those charged with governance who will communicate regarding particular matters, the auditor's expectation that the communication will be 2-way, the process for taking action and reporting back on matters communicated by the auditor, and the process for taking action and reporting back on matters communicated by those charged with governance. The communication process will vary with the circumstances, including the size and governance structure of the entity, how those charged with governance operate, and the auditor's view of the significance of the matters to be communicated. The importance of effective 2-way communication is evidenced by the statement in paragraph .62 of AU section 380 that if, in the auditor's judgment, the 2-way communication between the auditor and those charged with governance is not adequate, there is a risk the auditor may not have obtained all the audit evidence required to form an opinion on the financial statements.

7.12 Paragraph .23 of AU section 380 identifies the following matters that the auditor should communicate with those charged with governance:

- The auditor's responsibilities under GAAS
- An overview of the planned scope and timing of the audit
- Significant findings from the audit

AU section 325, *Communicating Internal Control Related Matters Identified in an Audit* (AICPA, *Professional Standards*, vol. 1), and paragraph 7.102 of this guide provide guidance pertaining to the communication of internal control related matters. AU section 316, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1), and paragraph 7.87 of this guide provide guidance pertaining to communication about possible fraud. Appendix A of AU section 380 contains a list of other AU sections that contain requirements for auditor communication with those charged with governance, and the matters that are required to be communicated by those sections. Nothing in AU section 380 precludes the auditor from communicating any other matters to those charged with governance.

Audit Risk

7.13 AU section 312, *Audit Risk and Materiality in Conducting an Audit* (AICPA, *Professional Standards*, vol. 1), states that audit risk is a function of the risk that the financial statements prepared by management are materially misstated and the risk that the auditor will not detect such material misstatement. The auditor should consider audit risk in relation to the relevant assertions related to individual account balances, classes of transactions, and disclosures and at the overall financial statement level.

7.14 At the account balance, class of transactions, relevant assertion, or disclosure level, audit risk consists of (*a*) the risks of material misstatement (consisting of inherent risk and control risk) and (*b*) the detection risk. Paragraph .23 of AU section 312 states that auditors should assess the risk of material misstatement at the relevant assertion level as a basis to design and perform further audit procedures (tests of controls or substantive procedures). It is not acceptable to simply deem risk to be "at the maximum." This assessment may be in qualitative terms such as high, medium, and low, or in quantitative terms such as percentages.

7.15 In considering audit risk at the overall financial statement level, the auditor should consider risks of material misstatement that relate pervasively to the financial statements taken as a whole and potentially affect many relevant assertions. Risks of this nature often relate to the entity's control environment and are not necessarily identifiable with specific relevant assertions at the class of transactions, account balance, or disclosure level. Such risks may be especially relevant to the auditor's consideration of the risks of material misstatement arising from fraud, for example, through management override of internal control.

Planning Materiality

7.16 Audit risk and materiality, among other matters, need to be considered together in designing the nature, timing, and extent of audit procedures and in evaluating the results of those procedures. The auditor's consideration of materiality is a matter of professional judgment and is influenced by the auditor's perception of the needs of users of financial statements. Materiality judgments are made in light of surrounding circumstances and necessarily involve both quantitative and qualitative considerations.

7.17 In accordance with paragraph .27 of AU section 312, the auditor should determine a materiality level for the financial statements taken as a whole when establishing the overall audit strategy for the audit. The auditor often may apply a percentage to a chosen benchmark as a step in determining materiality for the financial statements taken as a whole. Paragraph .28 of AU section 312 provides additional considerations for identifying an appropriate benchmark.

Tolerable Misstatement

7.18 The initial determination of materiality is made for the financial statement taken as a whole. However, the auditor should allow for the possibility that some misstatements of lesser amounts than the materiality levels could, in the aggregate, result in a material misstatement of the financial statements. To do so, the auditor should determine one or more levels of tolerable misstatement. Paragraph .34 of AU section 312 defines *tolerable misstatement* (or *tolerable error*) as the maximum error in a population (for example, the class of transactions or account balance) that the auditor is willing to accept. Such levels of tolerable misstatement are normally lower than the materiality levels.

Qualitative Aspects of Materiality

7.19 As indicated previously, judgments about materiality include both quantitative and qualitative information. As a result of the interaction of quantitative and qualitative considerations in materiality judgments, misstatements of relatively small amounts that come to the auditor's attention could have a material effect on the financial statements. For example, an illegal payment of an otherwise immaterial amount could be material if there is a reasonable possibility that it could lead to a material contingent liability or a material loss of revenue.

7.20 Qualitative considerations also influence the auditor in reaching a conclusion about whether misstatements are material. Paragraph .60 of AU section 312 provides qualitative factors that the auditor may consider relevant in determining whether misstatements are material.

Related Parties

7.21 AU section 334, *Related Parties* (AICPA, *Professional Standards*, vol. 1), provides guidance in determining the existence of related-party relationships and transactions with such parties such as those discussed in chapter 4 of this guide.

7.22 AU section 334 states that, in auditing related-party transactions that are identified during the course of the audit, the auditor should be aware that the substance of a particular transaction could be significantly different from its form and that financial statements should recognize the substance of particular transactions rather than merely their legal form. Except for routine transactions, it will generally not be possible to determine whether a particular transaction would have taken place if the parties had not been related, or assuming it would have taken place, what the terms and manner of settlement would have been. Accordingly, it is difficult to substantiate representations that a related-party transaction was consummated on terms equivalent to those that prevail in arm's-length transactions.

Use of Assertions in Obtaining Audit Evidence

7.23 Paragraphs .14–.19 of AU section 326, *Audit Evidence* (AICPA, *Professional Standards*, vol. 1), discuss the use of assertions in obtaining audit evidence. In representing that the financial statements are fairly presented in accordance with GAAP, management implicitly or explicitly makes assertions regarding the recognition, measurement, and disclosure of information in the financial statements and related disclosures. Assertions used by the auditor fall into the following categories.

Categories of Assertions

	Description of Assertions		
	Classes of Transactions and Events During the Period	*Account Balances at the End of the Period*	*Presentation and Disclosure*
Occurrence or Existence	Transactions and events that have been recorded have occurred and pertain to the entity.	Assets, liabilities, and equity interests exist.	Disclosed events and transactions have occurred.
Rights and Obligations	—	The entity holds or controls the rights to assets, and liabilities are the obligations of the entity.	Disclosed events and transactions pertain to the entity

Categories of Assertions—continued

	Description of Assertions		
	Classes of Transactions and Events During the Period	*Account Balances at the End of the Period*	*Presentation and Disclosure*
Completeness	All transactions and events that should have been recorded have been recorded.	All assets, liabilities, and equity interests that should have been recorded have been recorded.	All disclosures that should have been included in the financial statements have been included.
Accuracy or Valuation and Allocation	Amounts and other data relating to recorded transactions and events have been recorded appropriately.	Assets, liabilities, and equity interests are included in the financial statements at appropriate amounts and any resulting valuation or allocation adjustments are recorded appropriately.	Financial and other information is disclosed fairly and at appropriate amounts
Cut-off	Transactions and events have been recorded in the correct accounting period.	—	—
Classification and Understandability	Transactions and events have been recorded in the proper accounts.	—	Financial information is appropriately presented and described and information in disclosures is expressed clearly.

7.24 The auditor should use relevant assertions for classes of transactions, account balances, and presentation and disclosures in sufficient detail to form a basis for the assessment of risks of material misstatement and the design and performance of further audit procedures. The auditor should use relevant assertions in assessing risks by considering the different types of potential misstatements that may occur, and then designing further audit procedures that are responsive to the assessed risks.

Understanding the Entity, Its Environment, and Its Internal Control

7.25 AU section 314, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*, vol. 1), establishes requirements and provides guidance about implementing the second standard of field work, as follows:

> The auditor must obtain a sufficient understanding of the entity and its environment, including its internal control, to assess the risks of material misstatement of the financial statements whether due to error or fraud, and to design the nature, timing, and extent of further audit procedures.

7.26 Obtaining an understanding of the entity and its environment, including its internal control, is a continuous, dynamic process of gathering, updating, and analyzing information throughout the audit. Throughout this process, the auditor should also follow the guidance in AU section 316. See paragraphs 7.64–.89 for additional guidance pertaining to AU section 316.

7.27 This section addresses the unique aspects of CIRAs that may be helpful in developing the required understanding of the entity, its environment, and its internal control.

Risk Assessment Procedures

7.28 As described in AU section 326, audit procedures performed to obtain an understanding of the entity and its environment, including its internal control, to assess the risks of material misstatement at the financial statement and relevant assertion levels are referred to as *risk assessment procedures*. Paragraph .21 of AU section 326 states that the auditor must perform risk assessment procedures to provide a satisfactory basis for the assessment of risks at the financial statement and relevant assertion levels. Risk assessment procedures by themselves do not provide sufficient appropriate audit evidence on which to base the audit opinion and must be supplemented by further audit procedures in the form of tests of controls, when relevant or necessary, and substantive procedures.

7.29 In accordance with paragraph .06 of AU section 314, the auditor should perform the following risk assessment procedures to obtain an understanding of the entity and its environment, including its internal control:

a. Inquiries of management and others within the entity

b. Analytical procedures

c. Observation and inspection

See paragraphs .06–.13 of AU section 314 for additional guidance on risk assessment procedures.

Discussion Among the Audit Team

7.30 In obtaining an understanding of the entity and its environment, including its internal control, AU section 314 states that there should be discussion among the audit team. In accordance with paragraph .14 of AU section

314, the members of the audit team, including the auditor with final responsibility for the audit, should discuss the susceptibility of the entity's financial statements to material misstatements. This discussion could be held concurrently with the discussion among the audit team that is specified by AU section 316 to discuss the susceptibility of the entity's financial statements to fraud.

Understanding of the Entity and Its Environment

7.31 Paragraph .03 of AU section 314 states that obtaining an understanding of the entity and its environment is an essential aspect of performing an audit in accordance with GAAS. In accordance with paragraph .04 of AU section 314, the auditor should use professional judgment to determine the extent of the understanding required of the entity and its environment, including its internal control. The auditor's primary consideration is whether the understanding that has been obtained is sufficient (1) to assess risks of material misstatement of the financial statements and (2) to design and perform further audit procedures (tests of controls and substantive tests).

7.32 The auditor's understanding of the entity and its environment consists of an understanding of the following aspects:

a. Industry, regulatory, and other external factors

b. Nature of the entity

c. Objectives and strategies and the related business risks that may result in a material misstatement of the financial statements

d. Measurement and review of the entity's financial performance

e. Internal control, which includes the selection and application of accounting policies (see the following section for further discussion)

Refer to appendix A of AU section 314 for examples of matters that the auditor may consider in obtaining an understanding of the entity and its environment relating to categories (*a*)–(*d*) in the previous list. Some examples of matters the auditor may consider when obtaining and understanding of a CIRA and its environment are discussed in the paragraphs that follow.

A CIRA's Documents

7.33 The legal and other documents that create a CIRA generally describe the rights and responsibilities of those charged with governance and of the unit owners, and the CIRA's obligation to maintain the property and provide for future major repairs and replacements. In the planning phase of the audit, the auditor should review relevant documents, including bylaws, if any; the declarations for a condominium or homeowner's association (HOA); or for a cooperative housing corporation, the corporate charter, and master proprietary lease with the tenant-shareholders.

7.34 CIRAs may also be governed by state statutes or local ordinances, federal regulations, contracts, mortgage and finance agreements and other similar legally binding arrangements. Paragraph .05 of AU section 317, *Illegal Acts by Clients* (AICPA, *Professional Standards*, vol. 1), states the auditor considers laws and regulations that are generally recognized by auditors to have a direct and material effect on the determination of financial statement amounts. This paragraph also states that the auditor's responsibility to detect and report misstatements resulting from illegal acts having a direct and material effect on the determination of financial statement amounts is the same as that for errors and fraud as described in AU section 316. That is, based on an assessment of the risk that errors and fraud may cause the financial statements to include a material misstatement, the auditor should design the audit to provide reasonable assurance of detecting errors or fraud that are material to the financial statements. Paragraph .20 of AU section 316 states that the auditor should inquire of management about whether management has any knowledge of fraud or suspected fraud affecting the entity; AU section 317 does not contain such a requirement.

7.35 AU section 317 recognizes that entities may be affected by laws and regulations that relate more to an entity's operating aspects than to its financial and accounting aspects. The financial statement effect of such laws and regulations is usually indirect. State statutes and local ordinances that affect CIRAs are generally operational in nature and therefore have an indirect effect on financial statements. Even when violations of such laws and regulations can have consequences material to the financial statements, the auditor may not become aware of the existence of the illegal act unless he or she is informed by the client, or there is evidence of a governmental agency investigation or enforcement proceeding in the records, documents, or other information normally inspected in an audit of financial statements. Paragraphs .13–.15 of AU section 317 provide guidance and establish requirements for the auditor's consideration of the financial statement effect of illegal acts.

Minutes

7.36 The board of directors of a CIRA generally meets periodically. Minutes of those meetings are generally prepared. The minutes usually document such matters as approvals and revisions of budgets and assessments, authorizations for expenditures for capital improvements, approvals of contracts for services to be performed, and authorizations for changes in the management company's fees. Auditors should review available minutes and consider matters that may affect the CIRA's financial statements.

Management of a CIRA

7.37 The board of directors of a CIRA has the authority and responsibility to manage the CIRA. The board may engage a managing agent to provide various services. The agent normally operates under an arrangement (the management agreement) with the CIRA. The management agreement defines the relationship between the CIRA and the managing agent, presents details of the services to be performed, and states the fees for those services. The management agreement may provide for bookkeeping and accounting services in addition to bidding and evaluating contracts, collections, resolving disputes and similar services to be provided by the managing agent to the CIRA. Such services may affect the nature, timing, and extent of substantive audit procedures to be performed by the auditor of a CIRA. For example, a managing agent that provides the CIRA with bookkeeping and accounting services would normally meet the definition of a service organization as defined in paragraph .02 of AU section 324,[2] *Service Organizations* (AICPA, *Professional Standards*,

[2] The AICPA Audit Guide titled *Service Organizations: Applying SAS No. 70, as Amended* includes illustrative control objectives as well as three new interpretations that address the responsibilities of service organizations and service auditors with respect to forward-looking information, subsequent events, and the risk of projecting evaluations of controls to future periods. The guide also clarifies that the use of a service auditor's report should be restricted to existing customers and is not meant for potential customers.

vol. 1). AU section 324 provides guidance on the factors an independent auditor[3] should consider when auditing the financial statements of an entity that uses a service organization to process certain transactions.

Initial Operating Period

7.38 In obtaining an understanding of the CIRA and its environment, the auditor performing an audit of a CIRA's first period of operations should determine the date on which the CIRA's operations began. During the initial operating period, the CIRA's board of directors is generally controlled by the developer (declarant). The auditor should review documents such as closing statements to evaluate the completeness of the recording of initial working capital contributions such as one-time member assessments or escrow deposits, or both, collected from original unit owners on behalf of the CIRA. The following considerations related to the initial operating period are common in audits of CIRAs and, along with the auditor's assessment of the identified risks at the relevant assertion level, help provide a basis for designing and performing further audit procedures to obtain sufficient, appropriate audit evidence for all relevant assertions:

- Whether the developer (declarant) has fulfilled its obligation to pay assessments on unsold units or to fund operating deficits or contribute to the replacement fund, or both
- Whether the CIRA has paid for expenses related only to the CIRA and not for any developer (declarant) expenses, including expenses for the time period prior to date operations began
- Whether assets received from the developer (declarant) are reported in accordance with the guidelines for common property in this guide
- Whether contracts and agreements signed by the developer meet statutory or similar guidelines (some states prohibit developers from entering into contracts of longer than a certain number of years)
- Whether the transition period during which control was transferred from the developer to the CIRA was done in compliance with the declarations or other governing documents or statutory requirements

Budgets

7.39 Budgets are an important tool for a CIRA's management and those charged with governance in executing their respective administrative and fiduciary duties on behalf of the CIRA. For example, budgets often serve as the bases for assessments from unit owners. Other users of a CIRA's budget may include unit owners, prospective unit owners, auditors, and lenders. The auditor should consider the CIRA's budgeting procedures in obtaining an understanding of the entity and its environment, including its internal control and assessing the risks of material misstatement. See paragraph 7.90 in this guide for further discussion of an auditor's responsibilities for budgets included in auditor-submitted

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[3] A member performing an attest engagement must be *independent* pursuant to Ethics Rule 101, *Independence* (AICPA, *Professional Standards*, vol. 2, ET sec. 101 par. .01). Other applicable independence rules or regulations, or both, may also apply to members and other accountants while performing attest engagements (for example, Securities and Exchange Commission, Public Company Accounting Oversight Board, Government Accountability Office, and state licensing boards).

documents and for budgets included in client-prepared documents that also contain audited financial statements.

Understanding of Internal Control[4]

7.40 AU section 314 states that the auditor should obtain an understanding of the five components of internal control sufficient to assess the risks of material misstatement of the financial statements whether due to error or fraud, and to design the nature, timing, and extent of further audit procedures. The auditor should obtain a sufficient understanding by performing risk assessment procedures to

a. evaluate the design of controls relevant to an audit of financial statements.

b. determine whether they have been implemented.

In obtaining this understanding, the auditor considers how an entity's use of IT and manual procedures may affect controls relevant to the audit.

7.41 The auditor should use the understanding to

- identify types of potential misstatements.
- consider factors that affect the risks of material misstatement.
- design tests of controls, when applicable, and substantive procedures.

7.42 Obtaining an understanding of controls is different from testing the operating effectiveness of controls. The objective of obtaining an understanding of controls is to evaluate the design of controls and determine whether they have been implemented for the purpose of assessing the risks of material misstatement. In contrast, the objective of testing the operating effectiveness of controls is to determine whether the controls, as designed, prevent or detect a material misstatement.

7.43 Paragraph .41 of AU section 314 defines *internal control* as a process—effected by those charged with governance, management, and other personnel—designed to provide reasonable assurance about the achievement of the entity's objectives with regard to reliability of financial reporting, effectiveness and efficiency of operations, and compliance with applicable laws and regulations. Internal control consists of the following 5 interrelated components:

a. Control environment
b. Risk assessment
c. Control activities
d. Information and communication systems
e. Monitoring

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[4] For additional nonauthoritative guidance pertaining to internal control, refer to the following Technical Questions and Answers (TIS) sections in AICPA *Technical Practice Aids* issued in March 2008:

- TIS section 8200.05, "Testing the Operating Effectiveness of Internal Control"
- TIS section 8200.06, "The Meaning of Expectation of the Operating Effectiveness of Controls"
- TIS section 8200.07, "Considering a Substantive Audit Strategy"
- TIS section 8200.08, "Obtaining an Understanding of the Control Environment"
- TIS section 8200.09, "Assessing Inherent Risk"

Refer to paragraphs .40–.101 of AU section 314 for a detailed discussion of the internal control components.

7.44 Paragraph .70 of AU section 314 states that auditors should obtain sufficient knowledge of the control environment to understand the attitudes, awareness, and actions of those charged with governance concerning the entity's internal control and its importance in achieving reliable financial reporting. Paragraph .74 of AU section 314 states that the auditor should consider the collective effect on the control environment of strengths and weaknesses in various control elements. For example, the auditor might consider the following in obtaining an understanding of a CIRA's control environment:

- The role and qualifications of those charged with governance, the managing agent, if any, and the role of site staff employed by the CIRA, if an.
- The frequency of board meetings
- The qualifications of board members
- The extent of the involvement in the operations of the CIRA by those charged with governance
- The organizational structure (as defined by its governing documents)
- Management's failure to commit sufficient resources to address security risks presented by IT
- External influences (including regulatory and other reporting requirements)
- The existence, limits, and conditions of fidelity insurance for both the CIRA and management
- The existence, limits, and conditions of catastrophic insurance policies for property owned by the CIRA

7.45 Paragraph .83 of AU section 314 discusses obtaining sufficient knowledge of the information system, including the related business processes relevant to financial reporting. To understand a CIRA's information system relevant to financial reporting, the auditor should identify the individuals responsible for the accounting system, records, and internal control over financial reporting. That responsibility may be divided among

a. the managing agent, if any.
b. employees of the CIRA.
c. an outside accountant or bookkeeper.
d. the group (or subgroup) of those charged with governance or a member of that group.
e. an outside IT specialist that may be needed to place certain financial information online.
f. a combination of the preceding.

7.46 Paragraph .89 of AU section 314 defines *control activities* as the policies and procedures that help ensure that management directives are carried out. They help ensure that necessary actions are taken to address risks to the achievement of the entity's objectives. Control activities, whether automated or manual, have various objectives and are applied at various organizational and functional levels. The auditor may identify control activities in obtaining the understanding of the information system relevant to financial reporting objectives discussed in paragraph 7.45. The auditor should obtain an understanding of those control activities relevant to the audit. Paragraph .90 of AU section 314 states that the auditor should obtain an understanding of the process of reconciling detail to the general ledger for significant accounts. Also, control activities are relevant to the audit if the auditor is required to evaluate them as discussed in paragraphs .115–.117 of AU section 314 which relate to significant risks and risks for which substantive procedures alone do not provide sufficient appropriate audit evidence. The auditor might also consider the following in understanding a CIRA's control activities:

- The policies instituted by those charged with governance to insure proper authorization of transactions and activities
- Independent control over the bidding process for significant contracts, such as insurance
- The policy for comparing actual results with budgeted amounts and investigating significant variances
- Documentation of significant transactions in minutes from meetings of those charged with governance
- The use of a managing agent
- The use of association staff
- Billing and collection procedures, such as the use of a lock box
- Purchasing procedures, such as the use of competitive bidding
- Payment procedures, such as a requirement for board approval before invoices are paid
- Existence of a conflict of interest or ethics policy(ies), or both, for association staff and board members
- Professional designations of association staff including training and continuing education

7.47 If a CIRA uses a managing agent, the auditor might consider

- the extent to which the board of directors monitors and controls the managing agent's activities related to the CIRA.
- the use of imprest cash funds.
- the manner in which the managing agent is compensated, such as the use of a fixed fee or otherwise.
- the extent, if any, to which the managing agent commingles operating funds, deferred maintenance funds, and replacement funds with other associations under management.
- whether the CIRA maintains separate records for transactions initiated by the managing agent, if any.
- whether the CIRA controls funds separately from funds controlled by the managing agent.
- the policy or board review of managing agent reports.
- the frequency of managing agent reports.
- the control program used by the agent with respect to its client, the association.
- existence of a conflict of interest or ethics policy(ies), or both, for the managing agent.

- professional designations of managing agent.
- training and continuing education of managing agent and agent's staff.

Identifying and Evaluating Control Deficiencies

7.48 AU section 325 establishes requirements and provides guidance in identifying and reporting conditions that relate to an entity's internal control observed during an audit of financial statements. In an audit of the financial statements of a nonissuer, paragraph .04 of AU section 325 states that the auditor is not required to perform procedures to identify deficiencies in internal control, or to express an opinion on the effectiveness of the entity's internal control. However, during the course of an audit, the auditor may become aware of control deficiencies while obtaining an understanding of the entity's internal control, assessing the risks of material misstatement of the financial statements due to error or fraud, performing further audit procedures to respond to assessed risk, communicating with management or others (for example, internal auditors or governmental authorities), or otherwise. The auditor's awareness of control deficiencies varies with each audit and is influenced by the nature, timing, and extent of audit procedures performed, as well as other factors.

7.49 The auditor must evaluate identified control deficiencies and determine whether these deficiencies, individually or in combination, are significant deficiencies or material weaknesses as defined in AU section 325. The significance of a control deficiency depends on the potential for a misstatement, not on whether a misstatement actually has occurred. Accordingly, the absence of identified misstatements does not provide evidence that identified control deficiencies are not significant deficiencies or material weaknesses. When evaluating whether control deficiencies, individually or in combination, are significant deficiencies or material weaknesses, the auditor should consider the likelihood and magnitude of misstatement. Refer to AU section 325 for further guidance on evaluating control deficiencies and to paragraph 7.102 of this guide for guidance related to communicating internal control related matters identified in an audit.

Assessment of Risks of Material Misstatement and the Design of Further Audit Procedures

7.50 As previously stated, risk assessment procedures allow the auditor to gather the information necessary to obtain an understanding of the entity and its environment, including its internal control. This knowledge provides a basis for assessing the risks of material misstatement of the financial statements. These risk assessments are then used to design further audit procedures, such as tests of controls, substantive tests, or both. This section provides guidance on assessing the risks of material misstatement and how to design further audit procedures that effectively respond to those risks.

Assessing the Risks of Material Misstatement

7.51 Paragraph .102 of AU section 314 states that the auditor should identify and assess the risks of material misstatement at the financial statement level and at the relevant assertion level related to classes of transactions, account balances, and disclosures. For this purpose, the auditor should *a.* identify risks throughout the process of obtaining an understanding of the entity and its environment, including relevant controls that relate to the risks, and considering the classes of transactions, account balances, and disclosures in the financial statements.

b. relate the identified risks to what can go wrong at the relevant assertion level.

c. consider whether the risks are of a magnitude that could result in a material misstatement of the financial statements.

d. consider the likelihood that the risks could result in a material misstatement of the financial statements.

7.52 The auditor should use information gathered by performing risk assessment procedures, including the audit evidence obtained in evaluating the design of controls and determining whether they have been implemented, as audit evidence to support the risk assessment. The auditor should use the assessment of the risks of material misstatement at the relevant assertion level as the basis to determine the nature, timing, and extent of further audit procedures to be performed.

Identification of Significant Risks

7.53 In assessing the risks of material misstatement, the auditor should determine which of the identified risks are, in the auditor's judgment, risks that require special audit consideration (such risks are defined as *significant risks*). One or more significant risks normally arise on most audits. In exercising this judgment, the auditor should consider inherent risk to determine whether the nature of the risk, the likely magnitude of the potential misstatement including the possibility that the risk may give rise to multiple misstatements, and the likelihood of the risk occurring are such that they require special audit consideration. Refer to paragraphs .45 and .53 of AU section 318, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained* (AICPA, *Professional Standards*, vol. 1), for further audit procedures pertaining to significant risks.

Designing and Performing Further Audit Procedures

7.54 AU section 318 establishes requirements and provides guidance about implementing the third standard of field work, as follows:

> The auditor must obtain sufficient appropriate audit evidence by performing audit procedures to afford a reasonable basis for an opinion regarding the financial statements under audit.

7.55 To reduce audit risk to an acceptably low level, the auditor (1) should determine overall responses to address the assessed risks of material misstatement at the financial statement level and (2) should design and perform further audit procedures whose nature, timing, and extent are responsive to the assessed risks of material misstatement at the relevant assertion level. The purpose is to provide a clear linkage between the nature, timing, and extent of the auditor's further audit procedures and the assessed risks. The overall responses and the nature, timing, and extent of the further audit procedures to be performed are matters for the professional judgment of the auditor and should be based on the auditor's assessment of the risks of material misstatement.

Overall Responses

7.56 The auditor's overall responses to address the assessed risks of material misstatement at the financial statement level may include emphasizing to the audit team the need to maintain professional skepticism in gathering and evaluating audit evidence, assigning more experienced staff or those with specialized skills or using specialists, providing more supervision, or incorporating additional elements of unpredictability in the selection of further audit procedures to be performed. Additionally, the auditor may make general changes to the nature, timing, or extent of further audit procedures as an overall response, for example, performing substantive procedures at period end instead of at an interim date.

Further Audit Procedures

7.57 Further audit procedures provide important audit evidence to support an audit opinion. These procedures consist of tests of controls and substantive tests. The nature, timing, and extent of the further audit procedures to be performed by the auditor should be based on the auditor's assessment of risks of material misstatement at the relevant assertion level.

7.58 In some cases, an auditor may determine that performing only substantive procedures is appropriate. However, the auditor often will determine that a combined audit approach using both tests of the operating effectiveness of controls and substantive procedures is an effective audit approach.

7.59 The auditor should perform tests of controls when the auditor's risk assessment includes an expectation of the operating effectiveness of controls or when substantive procedures alone do not provide sufficient appropriate audit evidence at the relevant assertion level.

7.60 Regardless of the assessed risk of material misstatement, the auditor should design and perform substantive procedures for all relevant assertions related to each material class of transactions, account balance, and disclosure.

7.61 The auditor's substantive procedures should include the following audit procedures related to the financial statement reporting process:

- Agreeing the financial statements, including their accompanying notes, to the underlying accounting records
- Examining material journal entries and other adjustments made during the course of preparing the financial statements

The nature and extent of the auditor's examination of journal entries and other adjustments depend on the nature and complexity of the entity's financial reporting system and the associated risks of material misstatement.

Evaluating Misstatements

7.62 Based on the results of substantive procedures, the auditor may identify misstatements in accounts or notes to the financial statements. Paragraph .42 of AU section 312 states that auditors must accumulate all known and likely misstatements identified during the audit, other than those that the auditor believes are trivial and communicate them to the appropriate level of management. AU section 312 further states that auditors must consider the effects, both individually and in the aggregate, of misstatements (known and likely) that are not corrected by the entity. This consideration includes, among other things, the effect of misstatements related to prior periods.

7.63 For detailed guidance on evaluating audit findings and audit evidence, refer to AU section 312 and AU section 326, respectively.

Consideration of Fraud in a Financial Statement Audit

7.64 AU section 316 is the primary source of authoritative guidance about an auditor's responsibilities concerning the consideration of fraud in a financial statement audit. AU section 316 provides guidance to auditors in fulfilling their responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud as stated in paragraph .02 of AU section 110, *Responsibilities and Functions of the Independent Auditor* (AICPA, *Professional Standards*, vol. 1).

7.65 There are two types of misstatements relevant to the auditor's consideration of fraud in a financial statement audit:

- Misstatements arising from fraudulent financial reporting
- Misstatements arising from misappropriation of assets

7.66 Three conditions generally are present when fraud occurs. First, the board, management, or other employees have an *incentive* or are under *pressure,* which provides a reason to commit fraud. Second, circumstances exist—for example, the absence of controls, ineffective controls, or the ability of the board, management, or other employees to override controls—that provide an *opportunity* for a fraud to be perpetrated. Third, those involved are able to *rationalize* committing a fraudulent act.

The Importance of Exercising Professional Skepticism

7.67 Paragraph .13 of AU section 316 states that because of the characteristics of fraud, the auditor's exercise of professional skepticism is important when considering the risk of material misstatement due to fraud. Professional skepticism is an attitude that includes a questioning mind and a critical assessment of audit evidence. The auditor should conduct the engagement with a mindset that recognizes the possibility that a material misstatement due to fraud could be present, regardless of any past experience with the entity and regardless of the auditor's belief about management's honesty and integrity. Furthermore, professional skepticism requires an ongoing questioning of whether the information and evidence obtained suggests that a material misstatement due to fraud has occurred.

Discussion Among Engagement Personnel Regarding the Risks of Material Misstatement Due to Fraud[5]

7.68 Members of the audit team should discuss the potential for material misstatement due to fraud in accordance with the requirements of paragraphs .14–.18 of AU section 316. The discussion among the audit team members about

[5] The brainstorming session to discuss the entity's susceptibility to material misstatements due to fraud could be held concurrently with the brainstorming session required under AU section 314, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*, vol. 1), to discuss the potential of the risks of material misstatement.

the susceptibility of the entity's financial statements to material misstatement due to fraud should include a consideration of the known external and internal factors affecting the entity that might (*a*) create incentives or pressures for the board, management, and others to commit fraud, (*b*) provide the opportunity for fraud to be perpetrated, and (*c*) indicate a culture or environment that enables management to rationalize committing fraud. Communication among the audit team members about the risks of material misstatement due to fraud also should continue throughout the audit.

7.69 The following are examples of potential fraud risk factors specific to or significant for CIRAs. The risk factors included in the list are only examples and, accordingly, the auditor may wish to consider additional or different risk factors. Not all of these examples are relevant in all circumstances, and some may be of greater or lesser significance to CIRAs of different size or with different ownership characteristics or circumstances. Also, the order of the examples of risk factors provided is not intended to reflect their relative importance or frequency of occurrence. The factors are classified as those that relate to incentives and pressures to commit fraud, opportunities that might allow fraud to occur, and attitudes and rationalizations that might accommodate a fraudulent action.

Part 1: Fraudulent Financial Reporting

A. ***Incentives/Pressures.*** Financial stability or profitability is threatened by economic, industry, or entity operating conditions, such as (or indicated by)

1. the community association changes management companies and board members frequently.
2. the community association changes auditors frequently—ostensibly to avoid some type of disclosure.
3. the community association changes reserve study preparers frequently—ostensibly to seek lower reserve amounts and hence lower assessments.
4. the community association changes the preparer of insurable replacement cost valuations—ostensibly to seek lower property insurance limits and hence lower premiums.
5. reserve study preparers are under pressure to report longer useful lives of components, exclude certain components, and lower replacement costs, so that the report recommendations do not result in an unacceptable increase in monthly dues to catch up on reserves.
6. boards or management personnel may feel the pressure to establish an unrealistically low budget. Also, the board or management personnel could try to find ways to shift operating expenses to expenses of the major repairs and replacement fund, thereby distorting operating income.
7. managing agent or board member who has check signing authority.
8. boards or management personnel feel pressure to drop catastrophe insurance coverage.

B. ***Opportunities.***

1. The nature of the CIRA industry provides opportunities to engage in fraudulent financial reporting that can arise from the following:
   a. In CIRAs, there usually is a separation between *management* and the corporate officers of the CIRA. *Management*

may be a management company or an onsite manager that keeps accounting records and does financial management off site, away from the CIRA and the CIRA officers. Conversely, there may be no separation in that the self-managed association is *managed* solely by the board with no oversight.

b. Management companies have access to multiple bank accounts for a portfolio of clients and may be able to mask money movements among them. Similarly, because a vendor may do work for multiple clients within the management company portfolio, payments to a vendor from one client for work at another client CIRA would not raise suspicion for the reader.

c. Significant related-party transactions not in the ordinary course of business or with related entities not audited or audited by another firm. Board members live in the CIRA and have friendships that may improperly enter into consideration when hiring professionals and contractors.

2. There is ineffective monitoring of management or the board as a result of the following:

   a. CIRA board members and officers do not necessarily have business or financial skills and may not be diligent or keen readers of financial information supplied to them. For the typical board member, the CIRA may be the most complex business that the board member is associated with in a management or oversight capacity.

   b. The self-managed association may have no one to perform an oversight function.

3. Internal control components are deficient as a result of the following:

   a. Changes in internal controls are made by the management company without the knowledge or approval of CIRA corporate officers. Conversely, in the self-managed association, the board may be able to easily circumvent internal controls.

   b. Some CIRAs may not have effective internal control because they are managed by volunteers who are not aware of the need for and methods of establishing effective internal controls.

   c. Some management companies consist of very few employees which could result in a lack of segregation of duties.

C. *Attitudes/Rationalizations.*

1. Management company employees have no ownership interest or residual interest (pension) in the CIRA and no exposure to loss as a result of fraud within the CIRA's activities.
2. Boards are volunteers and they feel they *deserve* the perks (such as free landscaping or interior repairs) due to the time they put in for the association.
3. Managing agents may also feel they *deserve* the perks (such as free landscaping or interior repairs).

Part 2: Misappropriations of Assets

A. *Incentives/Pressures.*

1. Adverse relationships between the CIRA and employees with access to cash or other assets susceptible to theft may motivate those employees to misappropriate those assets. For example, adverse relationships may be created by management companies that are often owned by one person or a very small group of people. They have a few highly compensated employees, and the rest are lightly compensated (underpaid). CIRA employees are also typically underpaid. A CIRA that is volunteer-managed may put an undue work burden on one or more volunteers, who may feel pressure to *reward* himself or herself.

2. The CIRAs use similar products and services used by an employee or board member. Thus, it is easy to include one additional utility bill to the payment or payment for extra landscaping or office supplies.

3. CIRA staff could inappropriately use association resources for personal use especially if key staff lived very near the CIRA. For instance, a general manager could use maintenance staff to repair his or her unit.

B. *Opportunities.* Certain characteristics or circumstances may increase the susceptibility of assets to misappropriation. For example, opportunities to misappropriate assets increase in the following circumstances:

1. Some CIRAs serve low and moderate income people who may not have bank accounts, and therefore pay, bills, including CIRA dues, by cash.

2. Board members do not closely review the checks they sign. Sometimes checks are signed in advance or signed without backup of invoices. Some management companies have signatory power or use signature stamps or both.

3. The management contract gives the management company broad powers to spend and to negotiate contracts and to recommend or select vendors.

4. While ostensibly governed by a board of directors and established in corporate or "weak mayor" form, some CIRAs function under what is called a "strong mayor" governance model, where the president or another board member wields considerable power, and is highly involved in day to day management. The auditor should exercise a heightened degree of professional skepticism toward the person in these cases, since this person may exercise unusual power over the management company and the board of directors.

5. Management companies also may have their own landscape or repair and maintenance departments where the same employees can bill two different associations. Or, due to lack of competitive bidding by use of internal employees there is an overcharging of time and materials. There can also be duplication of product invoicing, when the same management company is providing services to multiple associations.

Obtaining the Information Needed to Identify the Risks of Material Misstatement Due to Fraud

7.70 AU section 314 establishes requirements and provides guidance about how the auditor obtains an understanding of the entity and its environment, including its internal control for the purpose of assessing the risk of material misstatement. In performing that work, information may come to the auditor's attention that should be considered in identifying risks of material misstatement due to fraud. As part of this work, the auditor should perform the following procedures to obtain information that is used (as described in paragraphs .35–.42 of AU section 316) to identify the risks of material misstatement due to fraud:

a. Make inquiries of the board, management, and others within the entity to obtain their views about the risks of fraud and how they are addressed (see paragraphs .20–.27 of AU section 316)

b. Consider any unusual or unexpected relationships that have been identified in performing analytical procedures in planning the audit (see paragraphs .28–.30 of AU section 316)

c. Consider whether one or more fraud risk factors exist (see paragraphs .31–.33 of AU section 316 and the appendix to AU section 316)

d. Consider other information that may be helpful in the identification of risks of material misstatement due to fraud (see paragraph .34 of AU section 316)

7.71 In planning the audit, the auditor also should perform analytical procedures relating to revenue with the objective of identifying unusual or unexpected relationships involving revenue accounts that may indicate a material misstatement due to fraudulent financial reporting. For example, in the CIRA industry an auditor may want to examine changes in laundry income by comparing it with prior year or budget amounts or both. In the case of laundry, an analysis of water and gas usage may be used to determine the projected revenue.

7.72 When designing substantive analytical procedures, the auditor also should evaluate the risk of management override of controls. As part of this process, the auditor should evaluate whether such an override might have allowed adjustments outside of the normal period-end financial reporting process to have been made to the financial statements. Such adjustments might have resulted in artificial changes to the financial statement relationships being analyzed, causing the auditor to draw erroneous conclusions. For this reason, substantive analytical procedures alone are not well suited to detecting fraud.

7.73 *Considering Fraud Risk Factors.* As indicated in item *c*, the auditor may identify events or conditions that indicate incentives or pressures, or both, to perpetrate fraud, opportunities to carry out the fraud, or attitudes or rationalizations, or both, to justify a fraudulent action. Such events or conditions are referred to as *fraud risk factors*. Fraud risk factors do not necessarily indicate the existence of fraud; however, they often are present in circumstances where fraud exists.

7.74 AU section 316 provides fraud risk factor examples that have been written to apply to most enterprises. Paragraph 7.69 to this chapter contains a list of fraud risk factors specific to the CIRA industry. Remember that fraud risk factors are only one of several sources of information an auditor considers when identifying and assessing risk of material misstatement due to fraud.

Identifying Risks That May Result in a Material Misstatement Due to Fraud[6]

7.75 In identifying risks of material misstatement due to fraud, it is helpful for the auditor to consider the information that has been gathered in accordance with the requirements of paragraphs .19–.34 of AU section 316. The auditor's identification of fraud risks may be influenced by characteristics such as the size, complexity, and ownership attributes of the entity. In addition, the auditor should evaluate whether identified risks of material misstatement due to fraud can be related to specific financial statement account balances or classes of transactions and related assertions, or whether they relate more pervasively to the financial statements as a whole. Certain accounts, classes of transactions, and assertions that have high inherent risk because they involve a high degree of management judgment and subjectivity also may present risks of material misstatement due to fraud because they are susceptible to manipulation by management. The following are some examples of accounts and classes of transactions related to CIRAs that may present risks of material misstatement due to fraud because they are susceptible to manipulation by management:

1. Cash
2. Inventory and supplies
3. Internet access
4. Electronic funds transfer and similar economic transactions over the Internet
5. Lack of effective fidelity insurance
6. Operating expenses (possible misclassifications to replacement or deferred maintenance fund)
7. Allowance for uncollectible receivables
8. Payables and accrued expenses
9. Special assessment expenses
10. Capital lease obligations

A Presumption That Improper Revenue Recognition Is a Fraud Risk

7.76 Material misstatements due to fraudulent financial reporting often result from an overstatement of revenues (for example, through premature revenue recognition or recording fictitious revenues) or an understatement of revenues (for example, through improperly shifting revenues to a later period). Therefore, the auditor should ordinarily presume that there is a risk of material misstatement due to fraud relating to revenue recognition (see paragraph .41 of AU section 316). For example, there is often pressure on the board of directors not to increase dues, and therefore there is increased pressure to understate expenses or overstate revenue in order to show a surplus for the year. Some revenue related considerations for CIRAs include

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[6] Paragraph .102 of AU section 314 states that the auditor should identify and assess the risk of material misstatement at the financial statement level and at the relevant assertion level related to classes of transactions, account balances, and disclosures. This requirement provides a link between the auditor's consideration of fraud and the auditor's assessment of risk and the auditor's procedures in response to those assessed risks.

1. use of fines and penalties as an unreasonable revenue source.
2. CIRAs that serve as seasonal, rather than year round homes to residents may have significant prepaid revenue from absentee members.
3. CIRA managers may place a resident in a unit, but still carry the unit on the books as vacant. The manager could then collect and keep the rent or CIRA assessments. Cooperatives are more susceptible to this practice than condominiums or HOAs; however, the opportunity also presents itself in condominiums and HOAs for units where there has been a bankruptcy stay.
4. resort and second home CIRAs with integrated rental operations provide the manager with an opportunity to hide short term rental income.
5. not matching special assessments with future expenses. The special assessment is in year 1 and the association wants to book it in year 1. However, the special assessment was for a specific purpose—of which the expense has not occurred or has not occurred in full.

A Consideration of the Risk of Management Override of Controls

7.77 Even if specific risks of material misstatement due to fraud are not identified by the auditor, there is a possibility that management override of controls could occur, and accordingly, the auditor should address that risk (see paragraph .57 of AU section 316) apart from any conclusions regarding the existence of more specifically identifiable risks. Specifically, the procedures described in paragraphs .58–.67 of AU section 316 should be performed to further address the risk of management override of controls. These procedures include (1) examining journal entries and other adjustments for evidence of possible material misstatement due to fraud, (2) reviewing accounting estimates for biases that could result in material misstatement due to fraud, and (3) evaluating the business rationale for significant unusual transactions.

7.78 Key estimates and related issues in the CIRA industry may include

1. future repairs and maintenance reserves.
2. extending remaining useful lives of assets unrealistically.
3. improperly excluding assets from reserve studies.

Wide diversity in practice exists as to how associations develop the reserves for future major repairs and deferred maintenance. Developers sometimes understate these estimates to keep maintenance assessments artificially low. There is a tendency to use prior years' numbers without getting reliable updates. Reserve study specialists and professional engineers may need to be consulted from time to time. Other limited procedures applicable to the unaudited supplementary information about future major repairs and replacements are discussed later in this chapter.

Assessing the Identified Risks After Taking Into Account an Evaluation of the Entity's Programs and Controls That Address the Risks

7.79 Paragraphs .43–.45 of AU section 316 establish requirements and provide guidance concerning an entity's programs and controls that address identified risks of material misstatement due to fraud. Controls that may exist at a CIRA include

1. requiring and checking that signature cards are updated when the board members or managers change.
2. requiring 2 signers for reserve withdrawals.
3. maintaining a reasonable budget process.
4. using lockboxes and electronic transfers for the collection of assessments.

7.80 The auditor should consider whether such programs and controls mitigate the identified risks of material misstatement due to fraud or whether specific control deficiencies exacerbate the risks. After the auditor has evaluated whether the entity's programs and controls have been suitably designed and placed in operation, the auditor should assess these risks taking into account that evaluation. This assessment should be considered when developing the auditor's response to the identified risks of material misstatement due to fraud.

Responding to the Results of the Assessment[7]

7.81 Paragraphs .46–.67 of AU section 316 provide requirements and guidance about an auditor's response to the results of the assessment of the risks of material misstatement due to fraud. The auditor responds to risks of material misstatement due to fraud in the following 3 ways:

a. A response that has an overall effect on how the audit is conducted—that is, a response involving more general considerations apart from the specific procedures otherwise planned (see paragraph .50 of AU section 316)

b. A response to identified risks involving the nature, timing, and extent of the auditing procedures to be performed (see paragraphs .51–.56 of AU section 316)

c. A response involving the performance of certain procedures to further address the risk of material misstatement due to fraud involving management override of controls, given the unpredictable ways in which such override could occur (see paragraphs .57–.67 of AU section 316 and paragraph 7.79 in this guide)

Evaluating Audit Evidence

7.82 Paragraphs .68–.78 of AU section 316 provide requirements and guidance for evaluating audit evidence. The auditor should evaluate whether analytical procedures that were performed as substantive tests or in the overall review stage of the audit indicate a previously unrecognized risk of material misstatement due to fraud. The auditor also should consider whether responses to inquiries throughout the audit about analytical relationships have been vague

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[7] Paragraph .03 of AU section 318, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained* (AICPA, *Professional Standards*, vol. 1), states that to reduce audit risk to an acceptably low level, the auditor should determine overall responses to address the assessed risk of material misstatement at the financial statement level and should design and perform further audit procedures whose nature, timing, and extent are responsive to the assessed risks of material misstatement at the relevant assertion level. See paragraphs .04–.07 of AU section 318. This requirement provides a link between the auditor's consideration of fraud and the auditor's assessment of risk and the auditor's procedures in response to those assessed risks.

or implausible, or have produced evidence that is inconsistent with other audit evidence accumulated during the audit.

7.83 At or near the completion of fieldwork, the auditor should evaluate whether the accumulated results of auditing procedures and other observations affect the assessment of the risks of material misstatement due to fraud made earlier in the audit. As part of this evaluation, the auditor with final responsibility for the audit should ascertain that there has been appropriate communication with the other audit team members throughout the audit regarding information or conditions indicative of risks of material misstatement due to fraud.

Responding to Misstatements That May Be the Result of Fraud

7.84 When audit test results identify misstatements in the financial statements, the auditor should consider whether such misstatements may be indicative of fraud. See paragraphs .75–.78 of AU section 316 for requirements and guidance about an auditor's response to misstatements that may be the result of fraud. If the auditor believes that misstatements are or may be the result of fraud, but the effect of the misstatements is not material to the financial statements, the auditor nevertheless should evaluate the implications, especially those dealing with the organizational position of the person(s) involved.

7.85 If the auditor believes that the misstatement is or may be the result of fraud, and either has determined that the effect could be material to the financial statements or has been unable to evaluate whether the effect is material, the auditor should

a. attempt to obtain additional audit evidence to determine whether material fraud has occurred or is likely to have occurred, and, if so, its effect on the financial statements and the auditor's report thereon.[8]

b. consider the implications for other aspects of the audit (see paragraph .76 of AU section 316).

c. discuss the matter and the approach for further investigation with those charged with governance and an appropriate level of management that is at least one level above those involved, and with senior management and those charged with governance.[9]

d. if appropriate, suggest that the client consult with legal counsel.

7.86 The auditor's consideration of the risks of material misstatement and the results of audit tests may indicate such a significant risk of material misstatement due to fraud that the auditor should consider withdrawing from the engagement and communicating the reasons for withdrawal to those charged with governance. The auditor may wish to consult with legal counsel when considering withdrawal from an engagement.

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[8] See AU section 508, *Reports on Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1), for guidance on auditors' reports issued in connection with audits of financial statements.

[9] If the auditor believes senior management may be involved, discussion of the matter directly with the audit committee, or other appropriate subgroup of those charged with governance, may be appropriate.

Communicating About Possible Fraud to Management, Those Charged With Governance, and Others

7.87 Whenever the auditor has determined that there is evidence that fraud may exist, that matter should be brought to the attention of an appropriate level of management. See paragraphs .79–.82 of AU section 316 for further requirements and guidance about communications with management, those charged with governance, and others.

Documenting the Auditor's Consideration of Fraud

7.88 Paragraph .83 of AU section 316 identifies matters the auditor should document related to the auditor's consideration of fraud.

Practical Guidance

7.89 The AICPA Practice Aid *Fraud Detection in a GAAS Audit—Revised Edition* provides a wealth of information and help on complying with the provisions of AU section 316. Moreover, this practice aid will assist auditors in understanding the requirements of AU section 316 and whether current audit practices effectively incorporate these requirements. This practice aid is an *other auditing publication* as defined in AU section 150. Other auditing publications have no authoritative status; however, they may help the auditor understand and apply Statements on Auditing Standards (SASs).

Budgets

7.90 CIRAs may present accompanying information, such as budgets, in an auditor-submitted document that contains the CIRA's audited financial statements and the auditor's report thereon. AU section 551, *Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents* (AICPA, *Professional Standards*, vol. 1), states that when an auditor submits documents containing audited financial statements to a client or to others, he or she has a responsibility to report on all the information included in the document. Budget information for *unexpired* periods is considered to be prospective financial information subject to the reporting requirements in AT section 301, *Financial Forecasts and Projections* (AICPA, *Professional Standards*, vol. 1). Budget information for *expired* periods that accompanies audited financial statements in an auditor-submitted document is subject to the reporting requirements established in AU section 551. Because such information is generally not susceptible to auditing procedures, it is usually necessary for the auditor to disclaim an opinion on such information. The following is an example of a disclaimer of opinion that would be appropriate in such circumstances:

> Our audit was conducted for the purpose of forming an opinion on the basic financial statements taken as a whole. The budget information is presented for purposes of additional analyses and is not a required part of the basic financial statements. Such information has not been subjected to the auditing procedures applied in the audit of the basic financial statements, and, accordingly, we express no opinion on it.

CIRAs may prepare and publish various documents containing information in addition to audited financial statements and the auditor's report thereon. Paragraph .04 of AU section 550, *Other Information in Documents Containing Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1), states that, at a minimum, the auditor read such other information and consider whether the information, or the manner of its presentation, are materially consistent with information, or the manner of its presentation, appearing in the financial statements. Paragraph .07 of AU section 550 states that if certain other information[10] has been subjected to auditing procedures applied in the audit of the basic financial statements, the auditor may express an opinion on whether the information is fairly stated in all material respects in relation to those financial statements taken as a whole. In those circumstances, the auditor's report on the information should describe clearly the character of the auditor's work and the degree of responsibility the auditor is taking. The auditor may report on such information using the guidance provided and requirements set forth in paragraphs .12 and .14 of AU section 551.

7.91 AU section 329, *Analytical Procedures* (AICPA, *Professional Standards*, vol. 1), provides guidance and sets forth requirements on the use of analytical procedures. Paragraph .04 of AU section 329 states that analytical procedures should be applied to some extent for purposes of planning the nature, timing, and extent of other auditing procedures and as an overall review of the financial information in the final review stage of all audits. The auditor should compare budgeted amounts with actual amounts as an analytical procedure in the audit of a CIRA. Paragraph .14 of AU section 318 states that the auditor should obtain audit evidence about the completeness and accuracy of nonfinancial information if the auditor uses such information in performing audit procedures. See AU section 318 for additional guidance.

7.92 If an accountant assists a CIRA in preparing its budget, he or she may be required to report on the budget. AT section 301 sets forth requirements and provides guidance for such engagements. An accountant plans, conducts, and reports the results of attest engagements in accordance with the 11 attestation standards identified in AT section 50, *SSAE Hierarchy* (AICPA, *Professional Standards*, vol. 1).

Audit Procedures for CIRAs

7.93 This section provides guidance on the more significant auditing procedures that the independent auditor may consider in the audits of CIRAs. In accordance with paragraph .07 of AU section 318, the nature, timing, and extent of these procedures should be based on the auditor's assessment of the risks of material misstatements at the assertion level. However, regardless of the assessed risks of material misstatement, the auditor should design and perform substantive procedures for all relevant assertions related to each material class of transactions, account balance, and disclosure.

Assessment Revenues

7.94 Audit procedures performed to obtain audit evidence about assessment revenues should include comparing total reported assessments for the period under audit with budgeted amounts and testing whether amounts assessed to individual owners have been computed in accordance with the CIRA's documents.

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[10] This information may include supplementary information required by generally accepted accounting principles.

Assessments Receivable

7.95 In designing audit procedures for the relevant assertions, the following specific audit objectives related to a CIRA's assessments receivable are normally applicable:

- All assessments receivable owed to the CIRA at the balance-sheet date are recorded
- Recorded assessments receivable represent amounts owed to the CIRA at the balance-sheet date
- Assessments receivable are properly described and classified in the financial statements

The auditor may achieve these objectives by performing substantive tests or a combination of substantive tests and tests of controls. Substantive tests for determining the existence and accuracy of receivables includes confirmation of the amount receivable by direct communication with parties owing amounts to the entity being audited and tests of subsequent receipts. AU section 330, *The Confirmation Process* (AICPA, *Professional Standards*, vol. 1), provides guidance about the confirmation process in audits performed in accordance with GAAS.[11] If replies to confirmation requests are not received or if the replies are not satisfactory, the auditor should obtain satisfaction about the existence and accuracy of assessment receivable balances by alternative procedures such as examining subsequent cash receipts and the existence of liens filed against units, although such liens do not assure the collectibility of assessments receivable.

Investments

7.96 CIRAs often invest excess funds and reserve funds in savings accounts or other interest-bearing investments. In auditing investments, common audit objectives related to a CIRA's investments may include the following:

- Investments exist and the CIRA has legal title to them at the balance-sheet date.
- All investments owned by the CIRA at the balance-sheet date are included in the investment accounts.
- The values at which investments are carried in the financial statements are appropriate and are adequately disclosed.
- Investments pledged as collateral or otherwise restricted are appropriately identified and disclosed.
- Income from investments, including gains and losses on sales and adjustments in valuation allowances, is appropriately reflected in the financial statements.
- Investments conform to the CIRA's legal requirements and its governing documents.

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[11] AU section 9330, *The Confirmation Process: Auditing Interpretations of Section 330* (AICPA, *Professional Standards*, vol. 1), clarifies, among other matters, that the use of an electronic confirmation process is not precluded by the examples in AU section 330, *The Confirmation Process* (AICPA, *Professional Standards*, vol. 1). If the auditor is satisfied that the electronic confirmation process is secure and the confirmation is directly from a third party who is a bona fide authorized respondent, electronic confirmations may be considered as sufficient, valid confirmation responses. Readers may refer to this section for examples of validation techniques.

- Investments are insured or otherwise protected.
- Appropriate accrual of interest receivable is made.

The auditor may achieve these objectives by performing substantive tests or a combination of substantive tests and tests of controls. The auditor may confirm investments with the appropriate financial institution or custodian. Establishing the existence and ownership of investments is paramount to the audit process, particularly because many securities are readily negotiable.

Contracts

7.97 CIRAs often enter into agreements or contracts with agents or others not directly managed by the CIRA to provide services, such as operation of recreational facilities or garages, to unit owners. The auditor may find it necessary to review provisions of such contracts or agreements and consider whether the board was authorized to enter into the contracts and transactions pursuant to the contracts and whether related account balances are appropriately recorded and disclosed in the financial statements. The auditor should also evaluate whether commitments for long term contracts have been disclosed where required by GAAP.

Insurance

7.98 The auditor may consider whether a CIRA's insurance coverage complies with statutory or other documentary requirements. Although Financial Accounting Standards Board Statement No. 5, *Accounting for Contingencies*, does not require the disclosure of noninsured or underinsured risks, it states specifically that it does not discourage such disclosures.

Future Major Repairs and Replacements

7.99 CIRAs may be required by state statutes, mortgage documents, or their governing documents to set aside funds on a systematic basis for future major repairs and replacements. The auditor should review the CIRA's governing documents and relevant state statutes to determine whether such requirements exist. The auditor should also review the CIRA's policy for accumulating the required funds.

7.100 If the disclosure about a CIRA's funding for future major repairs and replacements as required by paragraph 4.27 of this guide is absent or inadequate, the auditor should consider modifying his or her report, as discussed in AU section 508, *Reports on Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1).

7.101 The auditor should apply certain limited procedures to the required supplementary information discussed in paragraph 4.33 of this guide. Paragraph .07 of AU section 558, *Required Supplementary Information* (AICPA, *Professional Standards*, vol. 1), provides guidance and sets forth requirements pertaining to required supplementary information. Specifically, procedures that the auditor should consider include the following:

- Determine by physical inspection of the property or review of the CIRA's legal or governing documents whether the disclosure about the CIRA's funding for future major repairs and replacements includes all major property components.

- Compare estimates of the costs of major repairs and replacements with current period expenditures and with the annual budget, if any.
- Inquire of management about whether the CIRA's property maintenance records, which reflect each component's replacement history, if any, were considered in determining the information to be disclosed.
- Inquire of management about whether the age and condition of the components were considered in determining the information and amounts to be disclosed.
- Check the mathematical accuracy of amounts disclosed.
- Inquire of management about whether the study was prepared by the board or a professional engineer and whether the methods and bases for estimating the amounts disclosed are documented. Consider whether those methods and bases are reasonable. If the study was conducted by the board, consider whether the source of the information used to estimate the useful lives and current or future repair and replacement costs, for example, bids from contractors or technical manuals on useful lives of various components are reasonable. Also, the auditor may consider determining whether or not the preparer has their reserve specialist designation as a way of confirming that the study was completed in conformance with the National Reserve Study Standards, which are referenced in chapter 3 of this guide.
- Inquire of management as to the age of the study.

Additional Auditing Considerations

Auditor's Communications Related to Internal Control Matters

7.102 Whenever an auditor expresses an opinion (including a disclaimer of opinion) on the financial statements of a nonissuer, paragraph .20 of AU section 325 states that the auditor must communicate, in writing, to management and those charged with governance, control deficiencies identified during the audit that are considered significant deficiencies or material weaknesses in the internal control process. The communication required byAU section 325 includes significant deficiencies and material weaknesses identified and communicated to management and those charged with governance in prior audits but not yet remediated. The written communication is best made by the report release date but should be made no later than 60 days following the report release date. Nothing precludes the auditor from communicating to management and those charged with governance other matters that the auditor believes to be of potential benefit to the entity or that the auditor has been requested to communicate which may include, for example, control deficiencies that are not significant deficiencies or material weaknesses. The auditor should not issue a written communication stating that no significant deficiencies were identified during the audit because of the potential for misinterpretation of the limited degree of assurance provided by such a communication.

Representation Letters

7.103 Paragraph .05 of AU section 333, *Management Representations* (AICPA, *Professional Standards*, vol. 1), states that written representations should be obtained from management for all financial statements and periods covered by the auditors report. Paragraph .09 of AU section 333 states that the management representation letter should be signed by those members of management with overall responsibility for financial and operating matters whom the auditor believes are responsible for and knowledgeable about, directly or through others in the organization, the matters covered by the representations. Where governance of a CIRA is the collective responsibility of a governing body, such as a CIRA's board of directors, and the board of directors performs management functions, the board of directors (or applicable members thereof) may be considered part of the CIRA's management.

7.104 AU section 380 defines management as those persons responsible for achieving the objectives of the entity and who have the authority to establish policies and make decisions by which those objectives are to be pursued. Management is also responsible for the financial statements, including designing, implementing, and maintaining effective internal control over financial reporting. CIRAs commonly contract with management companies whose responsibilities may vary and may include preparation of the financial statements. The auditor should evaluate, based on the guidance provided in AU section 333 and the definition of management in AU section 380, who should sign the representation letter, which may include a representative from the board of directors, a member of the CIRA's management on staff, a representative from the management company (for example, controller, association accountant, or its equivalent), or others, or some combination thereof.

7.105 Among CIRAs, it is common to have frequent turnover within the board of directors, as the members are typically volunteers. High turnover may also occur among the CIRA's management on staff and within the third-party management company, if applicable. Paragraph .10 of AU section 333 states, if current management was not present during all periods covered by the auditor's report, the auditor should nevertheless obtain written representations from current management on all such periods. If comparative financial statements are reported on, the representations obtained at the completion of the most recent audit should address all periods being reported on.

7.106 Paragraph .11 of AU section 380 states that the auditor may want to obtain written representations from other individuals. For example, the auditor may want to obtain written representations about the completeness of the minutes of the directors' meetings from the person responsible for keeping such minutes.

7.107 Paragraph .06 of AU section 333 identifies the matters to which specific representations should relate, including an acknowledgement by management that it has considered the financial statement misstatements aggregated by the auditor during the current engagement and pertaining to the latest period presented, and has concluded that any uncorrected misstatements are immaterial, both individually and in the aggregate, to the financial statements taken as a whole. A summary of the uncorrected misstatements should be included in or attached to the representation letter. The specific written representations obtained by the auditor will depend on the circumstances of the engagement and the nature and basis of presentation of the financial statements. The representation letter ordinarily should be tailored to include additional appropriate representations from management relating to matters specific to the entity's business or industry.

7.108 The auditor should consider obtaining representations about the following matters in addition to those described in AU section 333:

- Disclosures based on a study of future major repairs and replacements
- The CIRA's policy for funding future major repairs and replacements
- The CIRA's policy for disposing of the excess of revenues over expenses, if any

7.109 Paragraph .09 of AU section 333 states that the written representations should be addressed to the auditor. Because the auditor is concerned with events occurring through the date of the report that may require adjustment to or disclosure in the financial statements, the representations should be made as of the date of the auditor's report. Additionally, paragraph .12 of AU section 560, *Subsequent Events* (AICPA, *Professional Standards*, vol. 1), states that the auditor generally should obtain a letter of representations as to whether any events have occurred subsequent to the date of the financial statements being reported on by the independent auditor that, in the officer's (or other appropriate person's) opinion, would require adjustment or disclosure in the financial statements. A representation letter for an audit is illustrated in exhibit B-4 of appendix B.

Audit Documentation

7.110 Audit documentation is an essential element of audit quality. The form, content, and extent of audit documentation depends on the circumstances of the particular audit engagement and the audit methodology and tools used. The auditor must prepare audit documentation in connection with each engagement in sufficient detail to provide a clear understanding of the work performed (including the nature, timing, extent, and results of audit procedures performed), the audit evidence obtained and its source, and the conclusions reached. The quantity, type, and content of audit documentation are matters of the auditor's professional judgment. AU section 339, *Audit Documentation* (AICPA, *Professional Standards*, vol. 1), provides guidance and sets forth requirements about the content, ownership and confidentiality of audit documentation.

7.111 Paragraph .03 of AU section 339 states that audit documentation

- provides the principal support for the representation in the auditor's report that the auditor performed the audit in accordance with GAAS.[12]
- provides principal support for the opinion expressed regarding the financial information or the assertion to the effect that an opinion cannot be expressed.

Other purposes of audit documentation include, among other things, assisting the audit team to plan and perform the audit, assisting members of the audit team responsible for supervision to direct and supervise the audit work, retaining a record of matters of continuing significance to future audits of the

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[12] However, there is no intention to imply that the auditor would be precluded from supporting his or her report by other means in addition to audit documentation.

same entity, and enabling an experienced auditor to conduct inspections or peer reviews in accordance with applicable legal, regulatory, or other requirements.

7.112 Examples of audit documentation are audit programs,[13] analyses, memoranda, summaries of (and correspondence about) significant findings or issues, letters of confirmation and representation, abstracts or copies of entity documents, and schedules or commentaries prepared or obtained by the auditor. Audit documentation may be in paper form, electronic form, or other media.[14]

7.113 Paragraph .10 of AU section 339 states that the auditor should prepare audit documentation that enables an experienced auditor, having no previous connection to the audit, to understand

- the nature, timing, and extent of auditing procedures performed to comply with GAAS and applicable legal and regulatory requirements;
- the results of the audit procedures performed and the audit evidence obtained;
- the conclusions reached on significant matters; and
- that the accounting records agree or reconcile with the audited financial statements or other audited information.

In documenting the nature, timing, and extent of audit procedures performed, the auditor should record who performed the work and the date such work was completed. Additionally, it should be clear from the audit documentation who reviewed specific elements of the audit work performed and the date of such review. The requirement to document who reviewed the audit work performed does not imply a need for each specific working paper to include evidence of review.

7.114 The auditor should complete the assembly of the final audit file on a timely basis, but within 60 days following the report release date (documentation completion date). Statutes, regulations, or the audit firm's quality control policies may specify a shorter period of time in which this assembly process should be completed. After the documentation completion date, the auditor must not delete or discard audit documentation before the end of the specified retention period (generally not less than 5 years from the report release date but statutes, regulations, or the firm's quality control policies may specify a longer retention period). When the auditor finds it necessary to make an addition (including amendments) to audit documentation after the documentation completion date, the auditor should document the addition in accordance with paragraph .26 of AU section 339.

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[13] See paragraphs .19–.21 of AU section 311, *Planning and Supervision* (AICPA, *Professional Standards*, vol. 1), for guidance regarding preparation of audit programs.

[14] A firm of independent auditors has a responsibility to adopt a system of quality control policies and procedures to provide the firm with reasonable assurance that its personnel comply with applicable professional standards, including generally accepted auditing standards, and the firm's standards of quality in conducting individual audit engagements. Review of audit documentation and discussions with engagement team members are among the procedures a firm performs when monitoring compliance with the quality control policies and procedures that it has established. (Also, see AU section 161, *The Relationship of Generally Accepted Auditing Standards to Quality Control Standards* [AICPA, *Professional Standards*, vol. 1].) AU section 161 clarifies the relationship between Statements on Quality Control Standards and engagements performed under Statements on Auditing Standards.

7.115 Paragraph .23 of AU section 339 states that the auditor's report should not be dated earlier than the date on which the auditor has obtained sufficient appropriate audit evidence to support the opinion. Among other things, sufficient appropriate audit evidence includes evidence that the audit documentation has been reviewed and that the entity's financial statements, including disclosures, have been prepared and that management has asserted that it has taken responsibility for them. This will ordinarily result in a report date that is close to the date the auditor grants the entity permission to use the auditor's report in connection with the financial statements (report release date). Delays in releasing the report may require the auditor to perform additional procedures to comply with the requirements of AU section 560.

7.116 In addition to the requirements discussed in paragraphs 7.105–.110, AU section 339 establishes further requirements about the content, ownership, and confidentiality of audit documentation. Moreover, appendix A to AU section 339 lists the audit documentation requirements contained in other SASs.

Auditor's Report

7.117 Under certain circumstances, such as when the disclosure about funding for future major repairs and replacements required in paragraph 4.27 of this guide is inadequate, the auditor should consider whether to modify his or her opinion because of a departure from GAAP.

7.118 The auditor would not modify the report solely because the CIRA or unit owners have decided not to fund the CIRA's need for major repairs and replacements of common property even though the CIRA has determined current or future estimates of costs that may be required in the future.

7.119 The auditor may, however, decide to add an emphasis-of-matter paragraph to draw the user's attention to the note discussing funding for future major repairs and replacements. The following illustrates a paragraph that may be added to the standard report if the board of directors decides to only partially adopt the recommendations of a study:

> As more fully explained in note 4 to the financial statements, the board of directors has elected to only partially adopt the funding recommendations of a study conducted to determine current estimates of major repairs and replacements required in the future.

7.120 The following illustrates a paragraph that may be added to the standard report if owners vote not to fund for future major repairs and replacements:

> As more fully explained in note 4 to the financial statements, a majority of the unit owners voted not to fund the association's future needs for major repairs and replacements through systematic assessments.

7.121 In June 2004, the Auditing Standards Board (ASB) issued 2 interpretations of AU section 508 that provide reporting guidance for audits of nonissuers. Auditing Interpretation No. 17, "Clarification in the Audit Report of the Extent of Testing of Internal Control Over Financial Reporting in Accordance With Generally Accepted Auditing Standards" (AICPA, *Professional Standards*, vol. 1, AU sec. 9508 par. .85–.88), addresses how auditors may expand their independent auditor's report to explain that their consideration of internal control was to provide the auditor a sufficient understanding to plan the audit and determine the nature, timing, and extent of tests to be performed, but was not sufficient to express an opinion on the effectiveness of the internal control. Auditing Interpretation No. 18, "Reference to PCAOB Standards in an Audit Report on a Nonissuer" (AICPA, *Professional Standards*, vol. 1, AU sec. 9508 par. .89–.92), provides guidance on the appropriate referencing of Public Company Accounting Oversight Board (PCAOB) Auditing Standards in audit reports when an auditor is engaged to perform the audit in accordance with both GAAS and PCAOB Auditing Standards. The ASB also has undertaken a project to determine what amendments, if any, should be made to AU section 508. See the AICPA Web site at www.aicpa.org/download/auditstd/asb_2008_2010_timetable.pdf for more information on the project timetable.

Reporting on Required Supplementary Information

7.122 Paragraph 4.33 of this guide sets forth requirements for CIRAs to present supplementary information about estimates of current or future costs of major repairs and replacements of common property that will be required in the future. AU section 551 states that the auditor should (*a*) express an opinion on the information if the auditor has been engaged to examine the information, (*b*) report on the information using the guidance in AU section 551, provided such information has been subjected to the auditing procedures applied in the audit of the basic financial statements, or (*c*) disclaim an opinion on the information. The following is an example of a disclaimer that an auditor might use in conjunction with the presentation of such supplementary information outside the basic financial statements in an auditor-submitted document:

> The [*identify the supplementary information*] on page XX is not a required part of the basic financial statements but is supplementary information required by accounting principles generally accepted in the United States of America. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the supplementary information. However, we did not audit the information and express no opinion on it.

7.123 Because supplementary information generally is not audited and is not a required part of the basic financial statements, the auditor need not add an explanatory paragraph, notwithstanding the condition described in paragraph 7.122, to the report on the audited financial statements to refer to the supplementary information or to his or her limited procedures, except in the following circumstances:

a. The supplementary information that GAAP requires to be presented in the circumstances is omitted.

b. The auditor has concluded that the measurement or presentation of the supplementary information departs materially from prescribed guidelines.

c. The auditor is unable to complete the procedures prescribed in paragraph 7.101.

d. The auditor is unable to remove substantial doubts about whether the supplementary information conforms to prescribed guidelines.

7.124 The following illustrates a paragraph that may be added to the standard auditor's report if the unaudited supplementary information required in paragraph 4.33 of this guide is not presented. That information is required even if a CIRA's governing documents and state statutes do not require the CIRA to fund systematically for future major repairs and replacements:

> As discussed in note 4, the association has not estimated the remaining lives and replacement costs of the common property and, therefore, has not presented information on future major repairs and replacements that accounting principles generally accepted in the United States of America has determined is necessary to supplement, although not required to be part of, the basic financial statements.

7.125 The following illustrates an explanatory paragraph that an auditor might use in circumstances in which the supplementary information materially departs from information required by paragraph 4.33 of this guide:

> The supplementary information on future major repairs and replacements on page XX is not a required part of the basic financial statements, and we did not audit and do not express an opinion on such information. However, we have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the supplementary information. As a result of such limited procedures, we believe that the supplementary information on future major repairs and replacements is not in conformity with guidelines established by accounting principles generally accepted in the United States of America [*describe the material departures*].

7.126 The following illustrates an explanatory paragraph that an auditor might use in circumstances in which the procedures prescribed by paragraph 7.101 of this guide were not completed:

> The supplementary information on future major repairs and replacements on page XX is not a required part of the basic financial statements, and we did not audit and do not express an opinion on such information. Furthermore, we were unable to apply to the information certain procedures prescribed by professional standards because [*state the reasons*].

7.127 The following illustrates an explanatory paragraph that an auditor might use in circumstances in which the auditor has unresolved doubts about the adherence of the information to the information required by paragraph 4.33 of this guide:

> The supplementary information on future major repairs and replacements on page XX is not a required part of the basic financial statements, and we did not audit and do not express an opinion on such information. However, we have applied certain limited procedures prescribed by professional standards that raised doubts that we were unable to resolve regarding whether material modifications should be made to the information for it to conform with guidelines established by accounting principles generally accepted in the United States of America. [*The auditor should consider including in the report the reason(s) the auditor was unable to resolve these doubts.*]

7.128 Even though the auditor is unable to complete the prescribed procedures, if, on the basis of facts known to him or her, the auditor concludes that the supplementary information has not been measured or presented within prescribed guidelines, he or she should suggest appropriate revision; failing that, he or she should describe the nature of any material departure(s) in the report.

7.129 In conjunction with the audit of the financial statements, the auditor may subject the supplementary information to certain auditing procedures. If the procedures are sufficient to enable the auditor to express an opinion on whether the information is fairly stated in all material respects in relation to the financial statements taken as a whole, the auditor may expand the audit report in accordance with paragraph .07 of AU section 550. Paragraph .08 of AU section 558 states that the auditor need not present the supplementary information if it is omitted by the entity. Since the required supplementary information does not change the standards of financial accounting and reporting used for the preparation of the CIRA's basic financial statements, the omission of the supplementary information (among other circumstances described in paragraph .08 of AU section 558) does not affect the auditor's opinion on the fairness of presentation of such financial statements in conformity with GAAP. However, the auditor should add an explanatory paragraph to the report on the audited financial statements as described in AU section 558.

Chapter 8

Review and Compilation Engagements[1]

> In February 2008, the Accounting and Review Services Committee (ARSC), issued Statements on Standards for Accounting and Review Services (SSARS) No. 17, *Omnibus Statement on Standards for Accounting and Review Services—2008* (AICPA, *Professional Standards*, vol. 2), which amends some of the guidance for compilation and review engagements. SSARS No. 17 is effective for compilations and reviews of financial statements for periods ending on or after December 15, 2008, with early application permitted. This guide will be updated for SSARS No. 17 in the next edition.
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> Due to the issuance of SSARS No. 17, AR sections 100, 9100, 200, 300, 9300, and 400 (as they existed prior to being amended by SSARS No. 17) have been moved to AR sections 100A, 9100A, 200A, 300A, 9300A, and 400A, respectively, of *Professional Standards* until the effective date of SSARS No. 17. This guide references the "A" sections as appropriate because SSARS No. 17 has not been incorporated in this edition.
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> As part of the conforming changes to this guide, updated as of May 1, 2008, the ARSC has rescinded Statement of Position (SOP) 93-5, *Reporting on Required Supplementary Information Accompanying Compiled or Reviewed Financial Statements of Common Interest Realty Associations*. Interpretative guidance previously included in the SOP has been conformed and moved to chapter 8 of the guide.

8.01 The needs of common interest realty associations (CIRAs) for accounting services may vary significantly. Factors that management considers in determining its needs for an accountant's services include the CIRA's

- legal requirements (see paragraph 1.10 of this guide);
- size;
- annual operating and replacement fund budgets;
- total assets;
- scope of operations;
- internal control and use of external management agents; and
- degree of supervision by the board of directors.

8.02 State laws or regulations, or a CIRA's governing documents, may prescribe whether a CIRA should have its financial statements compiled, reviewed, or audited. An accountant engaged to compile a CIRA's financial statements may become aware that the CIRA is required to have a review or an audit, in which case it is important that the accountant notify management

[1] AR section 50, *Standards for Accounting and Review Services* (AICPA, *Professional Standards*, vol. 2), establishes a Statements on Standards for Accounting and Review Services (SSARS) hierarchy that identifies the appropriate authoritative and nonauthoritative guidance applicable to compilation and review engagements. Refer to AR section 50 for more information.

and the association board of directors that a compilation will not satisfy the applicable legal, regulatory, or contractual requirements. Similarly, an accountant engaged to review a CIRA's financial statements may become aware that the CIRA is required to have an audit, in which case notification to management is also important.

Engagement Letters for Compilation and Review Engagements

8.03 Paragraph .05 of AR section 100A, *Compilation and Review of Financial Statements* (AICPA, *Professional Standards*, vol. 2), states that the accountant should establish an understanding with the entity, preferably in writing, regarding services to be performed. The understanding should include a description of the nature and limitations of the services to be performed. Such an understanding may include the degree of responsibility that the accountant is taking with respect to the required supplementary information on future major repairs and replacements discussed in chapter 4 of this guide. The understanding should also include a description of the report, if a report is to be issued, as well as the following:

a. That the engagement cannot be relied upon to disclose errors, fraud,[2] or illegal acts.[3]

b. That the accountant will inform the appropriate level of management of any material errors and of any evidence or information that comes to the accountant's attention during the performance of compilation or review procedures that fraud or an illegal act may have occurred.[4] The accountant need not report any matters regarding illegal acts that may have occurred that are clearly inconsequential and may reach agreement in advance with the CIRA on the nature of any such matters to be communicated.

Engagement letters for reviews and compilations of financial statements of CIRAs are illustrated in exhibits B-2 and B-3 of appendix B.

Performance and Reporting Requirements for Compilation Engagements

8.04 The accountant is not required to make inquiries or perform other procedures to verify, corroborate, or review information supplied by the CIRA. However, the accountant may have made inquiries or performed other procedures. The results of such inquiries or procedures, knowledge gained from

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[2] For purposes of AR section 100A, *Compilation of Review of Financial Statements* (AICPA, *Professional Standards*, vol. 2), fraud is an intentional act that results in a misstatement in compiled or reviewed financial statements.

[3] For purposes of AR section 100A, illegal acts are violations of laws or government regulations, excluding fraud.

[4] Footnote 14 to paragraph .05 of AR section 100A states that whether an act is, in fact, fraudulent or illegal is a determination that is normally beyond the accountant's professional competence. An accountant, in reporting on financial statements, presents himself or herself as one who is proficient in accounting and compilation or review services. The accountant's training, experience, and understanding of the client and its industry may provide a basis for recognition that some client acts coming to his or her attention may be fraudulent or illegal. However, the determination as to whether a particular act is fraudulent or illegal would generally be based on the advice of an informed expert qualified to practice law or may have to await final determination by a court of law.

prior engagements, or the financial statements on their face may cause the accountant to become aware that information supplied by the CIRA is incorrect, incomplete, or otherwise unsatisfactory. If any evidence or information comes to the accountant's attention regarding fraud or an illegal act that may have occurred, the accountant should request that management consider the effect of the matter on the financial statements. Additionally, the accountant should consider the effect of the matter on his or her compilation report. In circumstances in which the accountant believes that the financial statements are materially misstated, the accountant should obtain additional or revised information. If the CIRA refuses to provide additional or revised information, the accountant should withdraw from the engagement.

8.05 Before submission, the accountant should read the financial statements and consider whether such financial statements appear to be appropriate in form and free from obvious material errors. In this context, the term *error* refers to mistakes in the compilation of financial statements, including arithmetical or clerical mistakes, and mistakes in the application of accounting principles, including inadequate disclosure.

8.06 Paragraphs .11–.20 of AR section 100A provide guidance and establish reporting requirements pertaining to compilation engagements for which the accountant might reasonably expect the financial statements to be used by a third party. Paragraphs .22–.25 of AR section 100A provide guidance and establish performance and reporting requirements pertaining to compilation engagements for which the accountant submits financial statements to a client that are not expected to be used by a third party. AR section 100A also provides guidance and establishes requirements relating to the emphasis of a matter, departures from generally accepted accounting principles (GAAP), restricted use reports, subsequent discovery of facts existing at the date of the report, independence, and communicating to management and others.

Performance and Reporting Requirements for Review Engagements

8.07 AR section 100A provides accountants with guidance and establishes requirements with respect to the inquiries, analytical procedures, and other procedures to be performed in a review engagement. Paragraphs .41–.48 of AU section 100A provide general guidance with respect to reporting on reviewed financial statements. AR section 100A also provides guidance and establishes requirements relating to the emphasis of a matter, departures from GAAP, restricted use reports, subsequent discovery of facts existing at the date of the report, independence, and communicating to management and others.

8.08 A review does not contemplate obtaining an understanding of internal control or assessing control risk, assessing fraud risks, tests of accounting records and of responses to inquiries by obtaining corroborating evidential matter, performance of procedures designed to detect material misstatements due to fraud or illegal acts, and certain other procedures ordinarily performed during an audit. Thus, a review does not provide assurance that the accountant will become aware of all significant matters that would be disclosed in an audit.

8.09 If any evidence or information comes to the accountant's attention regarding fraud or an illegal act that may have occurred, the accountant should request that management consider the effect of the matter on the financial statements. Additionally, the accountant should consider the effect of the matter on his or her review report. In circumstances in which the accountant believes the financial statements are materially misstated, the accountant should perform the additional procedures deemed necessary to achieve limited assurance that there are no material modifications that should be made to the financial statements in order for the statements to be in conformity with GAAP.

8.10 The accountant should apply analytical procedures to the financial statements to identify and provide a basis for inquiry about the relationships and individual items that appear to be unusual and that may indicate a material misstatement.[*] Analytical procedures should include

- developing expectations by identifying and using plausible relationships that are reasonably expected to exist based on the accountant's understanding of the entity and the industry in which the entity operates; and
- comparing recorded amounts, or ratios developed from recorded amounts, to expectations developed by the accountant.

Additional analytical procedures an accountant may consider performing when conducting a review of financial statements are provided in paragraph .92 of AR section 100A.

8.11 Expectations developed by the accountant in performing analytical procedures in connection with a review of financial statements ordinarily are less encompassing than those developed in an audit. Also, in a review, the accountant ordinarily is not required to corroborate management's responses with other evidence. However, the accountant should consider the reasonableness and consistency of management's responses in light of the results of other review procedures and the accountant's knowledge of the entity's business and the industry in which it operates.

8.12 The following are inquiries the accountant should consider making to members of management who have responsibility for financial and accounting matters when conducting a review of financial statements (see appendix B of AR section 100A for additional illustrative inquiries):

1. Whether the financial statements have been prepared in conformity with GAAP consistently applied
2. The CIRA's accounting principles and practices and the methods followed in applying them and procedures for recording, classifying, and summarizing transactions, and accumulating information for disclosure in the financial statements
3. Unusual or complex situations that may have an effect on the financial statements
4. Significant transactions occurring or recognized near the end of the reporting period
5. The status of uncorrected misstatements identified during the previous engagement
6. Questions that have arisen in the course of applying the review procedures

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[*] For review engagements to which SSARS No. 17 applies, paragraph .31 of AR section 100A is changed to state that, in a review engagement, the accountant must apply analytical procedures to the financial statements.

7. Events subsequent to the date of the financial statements that could have a material effect on the financial statements
8. Their knowledge of any fraud or suspected fraud affecting the entity involving management or others where the fraud could have a material effect on the financial statements, for example, communications received from employees, former employees, or others
9. Significant journal entries and other adjustments
10. Communications from regulatory agencies

8.13 Some specific procedures that may be performed on a review engagement of a CIRA include the following:

- A review of minutes of the meetings of the board of directors and annual meetings of owners
- A comparison of the actual revenue and expenditures to the current year's budget and to the prior year's actual revenue and expenditures
- Inquiries about late fees and lien filing procedures for delinquent member assessments
- Inquiries about violations of the CIRA's legal documents or state statutes
- Inquiries about the CIRA's income tax filing status in prior years
- Inquiries about whether local governments may be imposing property taxes on both the CIRA and unit owners for the same property
- Inquiries about restrictions on cash accounts
- Inquiries about special bank accounts, if any, not maintained in the general ledger
- Examination of the management contract

Representation Letters

8.14 Paragraph .34 of AR section 100A establishes a requirement that, for review engagements, written representations be obtained from management for all financial statements and periods covered by the accountant's review report. Paragraph .36 of AR section 100A states that the letter should be signed by those members of management whom the accountant believes are responsible for and knowledgeable, directly or through others in the organization, about the matters covered in the representation letter.[†] (A representation letter for a review engagement is illustrated in exhibit B-5 of appendix B.)

[†] For review engagements to which SSARS No. 17 applies, definitions are provided for the terms *those charged with governance* and *management*. *Management* is defined as the person(s) responsible for achieving the objectives of the entity and who have the authority to establish policies and make decisions by which those objectives are to be pursued. Management is responsible for the financial statements, including designing, implementing, and maintaining effective internal control over financial reporting. The term *those charged with governance* is defined as the person(s) with responsibility for overseeing the strategic direction of the entity and obligations related to the accountability of the entity, including overseeing the financial reporting process.SSARS No. 17 clarifies that governance of some entities is the collective responsibility of a governing body that may be carried out by a board of directors, a committee of the board of directors, a committee of management, partners, equivalent persons, or some combination thereof. Those charged with governance are specifically excluded from management, unless they perform management functions. As such, the CIRA's board of directors (or applicable members thereof), if performing management functions, may be considered part of the CIRA's management.

8.15 CIRAs commonly contract with management companies whose responsibilities may vary and may include preparation of the financial statements. The accountant may determine that representations be obtained from a representative of the board of directors, a member of the CIRA's management on staff, a representative from the management company (for example, controller, association accountant, or its equivalent), or others, or some combination thereof.

8.16 Among CIRAs, it is common to have frequent turnover within the board of directors because the members are typically volunteers. High turnover may also occur among the CIRA's management on staff and within the third-party management company, if applicable. Paragraph .36 of AR section 100A states that if current management was not present during all periods covered by the accountant's report, the accountant should nevertheless obtain written representations from current management on all such periods. If comparative financial statements are reported on, the representations obtained at the completion of the most recent review should address all periods being reported on. The specific written representations obtained by the accountant will depend on the circumstances of the engagement and the nature and basis of presentation of the financial statements.

8.17 In connection with a review of financial statements presented in accordance with GAAP, specific representations should relate to the following matters:[5]

- *a.* Management's acknowledgement of its responsibility for the fair presentation in the financial statements of financial position, results of operations, and cash flows in conformity with GAAP
- *b.* Management's belief that the financial statements are fairly presented in conformity with GAAP
- *c.* Management's acknowledgement of its responsibility to prevent and detect fraud
- *d.* Knowledge of any fraud or suspected fraud affecting the entity involving management or others where the fraud could have a material effect on the financial statements, including any communications received from employees, former employees, or others
- *e.* Management's full and truthful response to all inquiries
- *f.* Completeness of information
- *g.* Information concerning subsequent events

8.18 The representation letter ordinarily should be tailored to include additional appropriate representation from management relating to matters specific to the CIRA or its industry. The illustrative representation letter presented in paragraph .89 of AR section 100A contains various representations that may be appropriate in certain situations.

8.19 The written representations should be addressed to the accountant. Because the accountant is concerned with events occurring through the date of

[5] Specific representations also are applicable to financial statements presented in conformity with a comprehensive basis of accounting other than generally accepted accounting principles. The specific representations to be obtained should be based on the nature and basis of presentation of the financial statements being reviewed.

the report that may require adjustment to or disclosure in the financial statements, the representations should be made as of a date no earlier than the date of the accountant's report.‡

Documentation in a Review Engagement

8.20 The accountant should prepare documentation in connection with a review of financial statements, the form and content of which should be designed to meet the circumstances of the particular engagement. Documentation is the principal record of the review procedures performed and the conclusions reached by the accountant in performing the review. However, an accountant would not be precluded from supporting his or her review report by other means in addition to the review documentation. Such other means might include written documentation contained in other engagement (for example compilation) files or quality control files (for example consultation files) and in limited situations, oral explanations. Oral explanations should be limited to those situations in which the accountant finds it necessary to supplement or clarify information contained in the documentation. Oral explanations should not be the principal support for the work performed or the conclusions reached.

8.21 Because of the different circumstances in individual engagements, it is not possible to specify the form or content of the documentation the accountant should prepare. However, the documentation should include any findings or issues that in the accountant's judgment are significant, for example, the results of review procedures that indicate the financial statements could be materially misstated, including actions taken to address such findings, and the basis for the final conclusions reached.

8.22 The documentation of the inquiry and analytical procedures should include the following:

a. The matters covered in the accountant's inquiry procedures

b. The analytical procedures performed

c. The expectations as discussed in paragraph 8.10, where significant expectations are not otherwise readily determinable from the documentation of the work performed, and factors considered in the development of those expectations

d. Results of the comparison of the expectations to the recorded amounts or ratios developed from recorded amounts

e. Any additional procedures performed in response to significant unexpected differences arising from the analytical procedure and the results of such additional procedures

f. Unusual matters that the accountant considered during the performance of the review procedures, including their disposition

g. Communications, whether oral or written, to the appropriate level of management regarding fraud or illegal acts that come to the accountant's attention

h. The representation letter

‡ For review engagements to which SSARS No. 17 applies, paragraph .36 of AR 100A is changed to state that management's representations set forth in the management representation letter should be made as of the date of the accountant's review report.

Certain Disclosure Requirements for Compiled or Reviewed Financial Statements of CIRAs

Future Major Repairs and Replacements

8.23 Most CIRAs are required by law, mortgage documents and agreements, or their governing documents to establish a plan for funding future major repairs and replacements, and information about the funding should be disclosed in the notes to the financial statements as discussed in paragraph 4.27 of this guide. For compilation and review reports, excluding compilation reports in which substantially all note disclosures have been omitted and compilation reports presented in a prescribed form, paragraph .51 of AR section 100A states that the accountant should consider whether modification of the standard report is adequate to disclose departures from GAAP, including note disclosures, that are material to the financial statements. If the modification to the standard report is not adequate to indicate the deficiencies in the financial statements taken as a whole, the accountant should withdraw from the engagement and provide no further services with respect to those financial statements. Refer to paragraphs .51–.53 of AR section 100A for more information, including examples of compilation and review reports that disclose departures from GAAP.

Uncertainties, Including an Uncertainty About an Entity's Ability to Continue as a Going Concern

8.24 When, during the performance of compilation or review procedures, evidence or information comes to the accountant's attention that there may be an uncertainty about the entity's ability to continue as a going concern, or the accountant becomes aware of other material uncertainties such as pending or threatened litigation, for example, the accountant should consider the adequacy of management's disclosure of the uncertainty.[||]

8.25 Normally, neither an uncertainty, including an uncertainty about an entity's ability to continue as a going concern, nor an inconsistency in the application of accounting principles would cause the accountant to modify the standard report, provided the financial statements appropriately disclose such matters. Paragraphs .51–.53 of AR section 100A provide guidance and set forth requirements pertaining to the accountant's responsibilities when he or she determines that management's disclosure of the uncertainty is not adequate. Disclosure requirements with respect to uncertainties are included in SOP 94-6, *Disclosure of Certain Significant Risks and Uncertainties* (AICPA, *Technical Practice Aids*, ACC sec. 10,640), FASB Statement No. 5, *Accounting for Contingencies*, and other authoritative accounting literature.

8.26 If the accountant concludes that management's disclosure of the uncertainty regarding the entity's ability to continue as a going concern is adequate but further decides to include an emphasis of a matter paragraph with respect to the uncertainty in the accountant's compilation or review report, Accounting and Review Services Interpretation No. 29, "Reporting on an Uncertainty, Including an Uncertainty About an Entity's Ability to Continue as a

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[||] For compilation and review engagements to which this statement applies, SSARS No.17 provides additional guidance and sets forth additional requirements with respect to an accountant's consideration of the entity's ability to continue as a going concern for a reasonable period of time, not to exceed 1 year beyond the date of the financial statements being compiled or reviewed.

Going Concern," of AR section 100A (AICPA, *Professional Standards*, vol. 2, AR sec. 9100A par. .120–.129), provides that the accountant may use the following language:

> As discussed in Note X, certain conditions indicate that the company may be unable to continue as a going concern. The accompanying financial statements do not include any adjustments that might be necessary should the company be unable to continue as a going concern.

8.27 If the accountant determines that the disclosure of other material uncertainties is in accordance with GAAP but further decides to include an emphasis of a matter paragraph with respect to the uncertainty in an accountant's compilation or review report, Accounting and Review Services Interpretation No. 29 provides that the accountant may use the following language:

> As discussed in Note X, the company is currently named in a legal action. The company has determined that it is not possible to predict the eventual outcome of the legal action but has determined that the resolution of the action will not result in an adverse judgment that would materially affect the financial statements. Accordingly, the accompanying financial statements do not include any adjustments related to the legal action under FASB Statement No. 5, *Accounting for Contingencies*.

Reporting on Required Supplementary Information Accompanying Compiled or Reviewed Financial Statements of CIRAs

8.28 Paragraph .70 of AR section 100A states that when the basic financial statements are accompanied by information presented for supplementary analysis purposes, the accountant should clearly indicate the degree of responsibility, if any, he or she is taking with respect to such information. For purposes of applying the guidance in paragraph .70 of AR section 100A, required supplementary information is treated the same as supplementary information or accompanying information that is voluntarily presented.

8.29 When the accountant is engaged to compile the accompanying required supplementary information described in paragraph 4.33 of this guide, the guidance in paragraphs 8.04–.06 of this guide applies. When the accountant is engaged to review such required supplemental information, the guidance in paragraphs 8.07–.13 applies.

8.30 When the basic financial statements are accompanied by required supplementary information and the required supplementary information has been compiled, the accountant's report should, either as part of the report on the basic financial statements or in a separate report

a. refer to the required supplementary information, either by using a descriptive title or naming the page number of the document;

b. state that the accountant has compiled the accompanying required supplementary information from information that is the representation of management, without audit or review; and

c. state that the accountant does not express an opinion or any other form of assurance on the required supplementary information.

In addition, to clarify the nature of the required supplemental information, the accountant may include a statement that the required supplementary information is not a required part of the basic financial statements but is supplementary information required by GAAP.

An example of an additional paragraph that may be added to a compilation report follows:

> The [*identify the required supplementary information*] on page XX is not a required part of the basic financial statements but is supplementary information required by generally accepted accounting principles. We (I) have compiled [*identify the required supplementary information*] from information that is the representation of management of XYZ Company, without audit or review. Accordingly, we (I) do not express an opinion or any other form of assurance on the required supplementary information.

8.31 When the basic financial statements are accompanied by required supplementary information and the required supplementary information has been reviewed, the accountant's report should, either as part of the report on the basic financial statements or in a separate report

a. refer to the required supplementary information, either by using a descriptive title or naming the page number of the document; and

b. state that the accompanying required supplementary information has been subjected to the inquiry and analytical procedures applied in the review of the basic financial statements, and the accountant did not become aware of any material modifications that should be made to such required supplementary information.

In addition, to clarify the nature of the required supplemental information, the accountant may include a statement that the required supplementary information is not a required part of the basic financial statements but is supplementary information required by GAAP.

An example of an additional paragraph that may be added to a review report follows:

> The [*identify the required supplementary information*] on page XX is not a required part of the basic financial statements but is supplementary information required by generally accepted accounting principles. The required supplementary information has been subjected to the inquiry and analytical procedures applied in the review of the basic financial statements. We did not become aware of any material modifications that should be made to such required supplementary information.

8.32 If, on the basis of facts known to him or her, the accountant becomes aware that the required supplementary information departs materially from prescribed guidelines, the accountant should indicate in his or her report that the information does not conform to the guidelines and should describe the nature of any material departure(s). An example of a sentence that might be added to the illustrative paragraph presented in paragraphs 8.29–.30 follows:

> However, we believe that the required supplementary information about future major repairs and replacements of common property is not in conformity with generally accepted accounting principles because [*describe the material departure(s) from GAAP*].

8.33 When the compiled or reviewed financial statements are not accompanied by the required supplementary information, a paragraph should be added to the compilation or review report indicating that the required supplementary information has been omitted. The accountant need not present the required supplementary information in the accountant's report. The following is an example of a paragraph that the accountant might use in these circumstances:

> The Association has not presented [*describe the required supplementary information*] that is required by generally accepted accounting principles to supplement, although not required to be a part of, the basic financial statements.

Chapter 9

Cooperative Housing Corporations

9.01 This chapter provides guidance on generally accepted auditing standards and financial reporting principles and practices to audits of and for cooperative housing corporations and supplements the guidance contained in the other chapters of this guide.

9.02 A cooperative housing corporation (cooperative) is organized to acquire and hold title to property. Shares of stock or membership interests in the corporation are sold to a tenant-shareholder who is given the right to occupy a specific dwelling unit as a result of agreements with the corporation. That agreement is commonly referred to as a *proprietary lease* in conventionally financed cooperatives and an *occupancy agreement* in cooperatives, the mortgages of which are insured by the Department of Housing and Urban Development (HUD). A shareholder's rights include (*a*) the right to occupy a defined interior space as well as (*b*) an undivided interest in the cooperative's common property.

9.03 The governing documents of a cooperative give tenant-shareholders the right to participate in governing the cooperative. The board of directors is ordinarily required to inform tenant-shareholders of important financial and management matters.

9.04 The three basic forms of cooperatives are independent market-rate cooperatives, limited-equity cooperatives, and leasing cooperatives. Independent market-rate cooperatives are organized as corporations, the shares of which are sold at market value. Shares are normally bought and sold on the open market (usually through real estate listings), although they could be sold by the cooperative.

9.05 Bylaws of limited-equity cooperatives restrict the amount of appreciation when shares are sold by tenant-shareholders. Generally, such cooperatives have the option to repurchase the shares and resell them with only a small amount of appreciation to prevent the cost of shares in the cooperative from increasing because of inflation. Such cooperatives may also limit the amounts of dividends paid on the investments of tenant shareholders. Dividends, also referred to as patronage dividends, are year-end refunds of rents received from tenant shareholders in excess of actual expenses incurred by the corporation. If the governing documents so state, it is possible that no dividends are paid.

9.06 Limited-equity cooperatives are usually organized with government financing and are directed towards low and moderate-income buyers. Financing may be received from state or local housing agencies at interest rates below market or through various HUD programs.

9.07 Many leasing cooperatives are associated with outside investors. In such an arrangement, it is common for a cooperative to lease a building from an investor who receives all the tax benefits from owning the building. In some arrangements, the cooperative receives a fee for managing the building. The cooperative may buy the building when the lease expires. This form of cooperative is also used by housing authorities, which retain ownership of the buildings for the sole purpose of keeping units at below-market purchase prices.

9.08 The financial statements of cooperatives are generally presented like those of commercial entities. However, a cooperative may present financial statements using fund reporting. Because depreciation is a noncash item, it is often presented in the income statement as the last line item after all income and operating expenses have been listed.

9.09 Cooperatives should present the following:

- A balance sheet
- A statement of operations
- A statement of changes in shareholders' equity
- A statement of cash flows
- Notes to financial statements
- The supplementary information required by paragraph 4.33 of this guide

Balance Sheet

9.10 The balance sheet includes information on all assets and liabilities resulting from the cooperative's operations and shareholders' equity.

9.11 All property owned by a cooperative is presented on its balance sheets. Cooperatives generally own the real estate and have the ability to borrow and pledge their assets as collateral. Some cooperatives, therefore, do not accumulate funds for future major repairs and replacements. The notes to the financial statements should disclose a cooperative's funding policy, if any, for future major repairs and replacements, as discussed in chapter 4 of this guide.

9.12 Components of retained earnings or deficit should not be disclosed. Allocating a portion of retained earnings to an amount equal to accumulated depreciation is an unacceptable practice.

Statement of Operations

9.13 Statements of operations of cooperatives should present information about all revenues and expenses. Reported revenues should include all charges to tenant-shareholders and other income. If per-share data are deemed useful, they should be considered for disclosure in the notes to the financial statements.

Statement of Changes in Shareholders' Equity

9.14 A statement of retained earnings (deficit) may be combined with the statement of operations (see exhibit A-15 of appendix A). If there is activity in paid-in capital, a separate statement of shareholders' equity should be prepared.

Statement of Cash Flows

9.15 A cooperative's financial statements should include a statement of cash flows, as do the financial statements of other common interest realty associations.

Notes to Financial Statements

9.16 In addition to all the notes normally required by generally accepted accounting principles, the notes should include the disclosures discussed in chapter 4 of this guide.

9.17 A cooperative's financial statements should include the supplementary information required by paragraph 4.33 of this guide.

Income Tax Considerations

9.18 Cooperatives are generally taxed as regular corporations and, beginning with tax years ending on or after December 31, 2007, are required to file corporate tax returns on Form 1120-C. Cooperatives are taxed on the excess of rents and other patronage income over operating expenses incurred and not returned to tenant-shareholders at the end of the year, and on other net nonpatronage income.

9.19 If predetermined assessments collected from tenant-shareholders exceed expenditures paid or incurred, a refund to tenant-shareholders in the same year results in an adjustment in the cooperative's receipts from tenant-shareholders and only the net amount of receipts is included in income for income tax purposes. A cooperative can thus avoid being taxed on excess income by distributing cash in that amount as a *patronage dividend* to shareholders. Under the provisions of Internal Revenue Code (IRC) sections 1381–1388, cooperatives can deduct patronage dividends declared and paid within 8 and a half months after the end of the fiscal year. Such dividends are required to be paid 20 percent in cash and 80 percent constructively, with a qualified written notice of allocation, and are not included in gross income by tenant-shareholders, unless the property is used in a trade or business. If expenditures exceed the amount collected from tenant-shareholders in a taxable year, the excess is not deductible in that year, but may be carried back or forward, as applicable, to offset taxable income in previous, subsequent, or both previous and subsequent years. However, a separate accounting is required for patronage and nonpatronage net operating losses under IRC Section 172 because patronage losses cannot be offset against nonpatronage income.

9.20 IRC Section 216 defines the requirements that corporations must meet to be treated as cooperative housing corporations for tax purposes for that year as follows:

a. The corporation has only one class of stock outstanding.

b. Each shareholder is entitled to occupy a corporate-owned or leased unit for dwelling purposes solely as a result of stock ownership.

c. No shareholder is entitled to receive distributions that are in excess of the income and profits of the corporation, except in complete or partial liquidation of the corporation.

d. The corporation derives 80 percent or more of its gross income from tenant-shareholders in any year.

9.21 Under the IRC, cooperatives are allowed to depreciate the property they lease to tenant-shareholders. Pursuant to section 216(c) of the IRC, qualified tenant-shareholders in a qualified cooperative housing corporation are allowed to treat all or a portion of their stock as property subject to the allowance for depreciation under IRC section 167(a) if both of the following criteria are met:

a. The associated occupancy right or proprietary lease relates to a unit or lease that is itself depreciable or amortizable.

b. That occupancy right or lease is used by the tenant-shareholder in a trade or business or for the production of income.

Tenant-shareholders are allowed to deduct their proportionate shares of interest and real estate taxes paid or incurred by the cooperative. Those amounts are deductible only to the extent that tenant-shareholders' payments are current.

9.22 Assessments to fund future major repairs and replacements, which are required under state statutes, or by HUD or Federal Housing Administration (FHA) regulations and are not available for distributions to shareholders, are held to be capital contributions. Amounts collected for future major repairs and replacements in excess of state statute, HUD, or FHA requirements are considered to be surplus funds available for distribution and are, therefore, includable in the corporation's gross income unless the total amount assessed is recorded as a capital contribution.

9.23 Tenant-shareholders selling their shares of stock in cooperatives that have legal limitations on their resale prices may have to forfeit to the corporation proceeds in excess of legal resale prices, if any. If there are no restrictions on the use of these forfeitures, they are includable in the corporation's gross income.

9.24 Paragraphs 6.02–.03 of this guide discuss the applicability of subchapter T to cooperative housing corporations.

Financial Statements

9.25 Financial statements and notes for cooperatives are illustrated in exhibits A-14–A-17 of appendix A.

Auditor's Report

9.26 Chapter 7 of this guide provides guidance for auditors for circumstances that may require the report to be modified.

Appendix A

Illustrative Financial Statements

The following exhibits illustrate a fund accounting presentation and a set of nonfund accounting financial statements for condominium and homeowners' associations, as well as a set of financial statements for a cooperative housing corporation. The notes to the illustrative financial statements are representative of the basic kind of disclosure for CIRAs and may not all be necessary for some common interest realty associations (CIRAs). These illustrations are not intended to represent the only appropriate presentations and disclosures and may not include all disclosures and presentation items promulgated. A summary of the exhibits follows:

- Exhibits A-1–A-8 illustrate financial statements and supplementary information for a condominium association. Condominiums generally do not hold title to property transferred to them by the developers. Exhibits A-1–A-2 present a balance sheet and a statement of revenues and expenses using fund reporting in a multicolumn format with a total funds column for the current and prior years. Exhibit A-3 illustrates a statement of cash flows using the direct method. Exhibit A-4 illustrates a statement of cash flows using the indirect method. This set of financial statements reflects an interfund receivable and payable of $20,000, which the board of directors intends for the operating fund to repay to the replacement fund in the next fiscal year. The statements also disclose a transfer of $10,000 from the replacement fund to the operating fund, which is an amount that the board of directors does not intend for the operating fund to repay to the replacement fund.

- The illustrative notes in exhibit A-5 include alternative presentations for note 4, which discloses information about a CIRA's fund for future major repairs and replacements. Alternative A illustrates disclosure based on a study conducted by the board of directors. Alternative B is based on a study conducted by an independent consulting firm. Note 4 also illustrates disclosure for a loan from the replacement fund to the operating fund as well as a permanent transfer.

- Exhibits A-6–A-7 present detailed schedules of actual and budgeted amounts of revenues and expenses for the operating fund, and of changes in replacement fund balances. These schedules are not a required part of the basic financial statements; however, if they are included with the financial statements in an auditor-submitted document, the auditor should refer to AU section 551, *Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents* (AICPA, *Professional Standards*, vol. 1), as amended, for reporting guidance.

- Exhibit A-8 presents unaudited supplementary information required by paragraph 4.33 of this guide. Alternative A illustrates disclosure based on a study conducted by the board of directors and presents estimates of current replacement costs. Alternative B is based on a study conducted by an independent consulting firm and presents estimates of future replacement costs, which are calculated considering inflation and estimated investment income.

- Exhibits A-9–A-11 illustrate, respectively, a homeowners' association's balance sheet, statement of revenues and expenses, and statement of cash flows for a presentation using nonfund-reporting financial statements.[1] Exhibit A-12 illustrates a statement of changes in members' equity, which would be presented with those financial statements. The statements reflect common real property that has been reported as assets of a CIRA.
- Exhibit A-13 illustrates a schedule of expenditures for major repairs and replacements. This schedule is not a required part of the basic financial statements; however, if it is included in an auditor-submitted document, the auditor should refer to AU section 551 for reporting guidance.
- Exhibits A-14–A-17 present financial statements and notes for a cooperative housing corporation.
- Exhibit A-18 presents unaudited supplementary information, based on a study conducted by the board of directors, for a cooperative housing corporation required by paragraph 4.33 of this guide and presents estimates of current replacement costs.

The financial statements illustrated do not include immaterial amounts.

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[1] Paragraphs 4.01–.02 of this guide state that nonfund reporting is permitted, although fund reporting is preferred.

Exhibit A-1

XYZ Condominium Association, Inc.
Balance Sheets
as of December 31, 20X7
(With Comparative Totals for 20X6)

	20X7			20X6
	Operating Fund	*Replacement Fund*	*Total*	*Total*
ASSETS				
Cash and cash equivalents	$ 110,000	$ 364,000	$ 474,000	$ 298,000
Assessments receivable	28,000		28,000	9,000
Prepaid expenses	7,000		7,000	7,000
Due from operating fund		20,000	20,000	
Due to replacement fund	(20,000)		(20,000)	
Equipment, net of accumulated depreciation of $8,000 and $5,000	21,000		21,000	17,000
TOTAL ASSETS	$ 146,000	$ 384,000	$ 530,000	$ 331,000
LIABILITIES				
Account payable	$ 20,000	$ 4,000	$ 24,000	$ 6,000
Wages payable	6,000		6,000	
Income taxes payable		1,000	1,000	5,000
Prepaid assessments	20,000		20,000	15,000
	46,000	5,000	51,000	26,000
	100,000	379,000	479,000	305,000
FUND BALANCES				
TOTAL LIABILITIES AND FUND BALANCES	$ 146,000	$ 384,000	$ 530,000	$ 331,000

The accompanying notes are an integral part of the financial statements.

Exhibit A-2

XYZ Condominium Association, Inc.
Statements of Revenues and Expenses
and Changes in Fund Balances
for the Year Ended December 31, 20X7
(With Comparative Totals for 20X6)

	20X7 Operating Fund	*20X7* Replacement Fund	*20X7* Total	*20X6* Total
REVENUES				
Member assessments	$ 747,000	$ 247,000	$ 994,000	$ 909,000
Interest		49,000	49,000	46,000
Lawsuit settlements		141,000	141,000	91,000
Other	22,000		22,000	20,000
TOTAL REVENUES	769,000	437,000	1,206,000	1,066,000
EXPENSES				
Wages and benefits	294,000		294,000	284,000
Utilities	160,000		160,000	141,000
Roofs		144,000	144,000	160,000
Service and contracts	129,000		129,000	134,000
Exterior siding		94,000	94,000	98,000
Repairs and supplies	92,000		92,000	61,000
Insurance and licenses	50,000		50,000	46,000
Administrative	28,000		28,000	18,000
Income taxes	1,000	11,000	12,000	13,000
Legal fees		10,000	10,000	
Recreational equipment		5,000	5,000	2,000
Solar equipment		5,000	5,000	
Streets		4,000	4,000	20,000
Tennis courts				12,000
Depreciation	3,000		3,000	3,000
Bad debts	2,000		2,000	
Pools and spas				18,000
TOTAL EXPENSES	759,000	273,000	1,032,000	1,010,000
Excess of revenues over expenses	10,000	164,000	174,000	56,000
Beginning fund balances	80,000	225,000	305,000	249,000
Transfer from replacement fund	10,000	(10,000)		
ENDING FUND BALANCES	$ 100,000	$ 379,000	$ 479,000	$ 305,000

The accompanying notes are an integral part of the financial statements.

Exhibit A-3

Direct Method

XYZ Condominium Association, Inc.
Statement of Cash Flows
for the Year Ended December 31, 20X7
(With Comparative Totals for 20X6)

	20X7			*20X6*
	Operating Fund	*Replacement Fund*	*Total*	*Total*
Cash flows from operating activities:				
Member assessments collected	$ 733,000	$ 247,000	$ 980,000	$ 920,000
Interest received		49,000	49,000	46,000
Lawsuit settlement		141,000	141,000	91,000
Other income received	22,000		22,000	20,000
Cash paid for operating expenditures[2]	(735,000)		(735,000)	(673,000)
Replacement expenditures paid		(258,000)	(258,000)	(310,000)
Income taxes paid	(1,000)	(15,000)	(16,000)	(26,000)
Transfers from replacement fund	10,000	(10,000)		
Net borrowings from replacement fund	20,000	(20,000)		
Net cash provided by operating activities	49,000	134,000	183,000	68,000
Cash flows from investing activities:				
Equipment purchases	(7,000)		(7,000)	(3,000)
Net increase in cash and cash equivalents	42,000	134,000	176,000	65,000
Cash and cash equivalents at beginning of year	68,000	230,000	298,000	233,000
Cash and cash equivalents at end of year	$ 110,000	$ 364,000	$ 474,000	$ 298,000

(*continued*)

The accompanying notes are an integral part of the financial statements.

[2] As an alternative presentation, this line item can be further detailed as shown in exhibit A-11.

XYZ Condominium Association, Inc.
Statement of Cash Flows
for the Year Ended December 31, 20X7
(With Comparative Totals for 20X6)—continued

	20X7			*20X6*
	Operating Fund	*Replacement Fund*	*Total*	*Total*
Reconciliation of excess of revenues over expenses to net cash provided by operating activities:				
Excess of revenues over expenses	$ 10,000	$ 164,000	$ 174,000	$ 56,000
Adjustments to reconcile excess of revenues over expenses to net cash provided by operating activities:				
Increase (decrease) in interfund balances	20,000	(20,000)		
Transfers from replacement fund	10,000	(10,000)		
Depreciation	3,000		3,000	3,000
Increase in assessments receivable	(19,000)		(19,000)	(1,000)
Decrease in prepaid expenses				1,000
Increase in accounts payable	14,000	4,000	18,000	2,000
Increase in wages payable	6,000		6,000	
Decrease in income taxes payable		(4,000)	(4,000)	
Increase in prepaid assessments	5,000		5,000	7,000
Total adjustments	39,000	(30,000)	9,000	12,000
Net cash provided by operating activities	$ 49,000	$ 134,000	$ 183,000	$ 68,000

The accompanying notes are an integral part of the financial statements.

Exhibit A-4

Indirect Method

XYZ Condominium Association, Inc.
Statement of Cash Flows
for the Year Ended December 31, 20X7
(With Comparative Totals for 20X6)

	20X7			*20X6*
	Operating Fund	*Replacement Fund*	*Total*	*Total*
Excess of revenues over expenses	$ 10,000	$ 164,000	$ 174,000	$ 56,000
Adjustments to reconcile excess of revenues over expenses to net cash provided by operating activities:				
Increase (decrease) in interfund balances	20,000	(20,000)		
Transfers from replacement fund	10,000	(10,000)		
Depreciation	3,000		3,000	3,000
Increase in assessments receivable	(19,000)		(19,000)	(1,000)
Decrease in prepaid expenses				1,000
Increase in accounts payable	14,000	4,000	18,000	2,000
Increase in wages payable	6,000		6,000	
Decrease in income taxes payable		(4,000)	(4,000)	
Increase in prepaid assessments	5,000		5,000	7,000
Total adjustments	39,000	(30,000)	9,000	12,000
Net cash provided by operating activities	49,000	134,000	183,000	68,000
Cash flows from investing activities:				
Equipment purchases	(7,000)		(7,000)	(3,000)
Net increase in cash and cash equivalents	42,000	134,000	176,000	65,000
Cash and cash equivalents at beginning of year	68,000	230,000	298,000	233,000
Cash and cash equivalents at end of year	$ 110,000	$ 364,000	$ 474,000	$ 298,000

The accompanying notes are an integral part of the financial statements.

Exhibit A-5

XYZ Condominium Association, Inc.
Notes to Financial Statements
December 31, 20X7 and 20X6

1. Organization

The XYZ Condominium Association is a statutory condominium association organized as a not-for-profit corporation for the purposes of maintaining and preserving common property of the XYZ condominium. The XYZ condominium consists of 800 residential units occupying a site of approximately 10 acres located at ______. The association began its operations in June 20XX.

2. Summary of Significant Accounting Policies

Pervasiveness of Estimates. The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Fund accounting. The association uses fund accounting, which requires that funds, such as operating funds, deferred maintenance funds, and funds designated for future major repairs and replacements, be classified separately for accounting and reporting purposes. Disbursements from the operating fund are generally at the discretion of the board of directors and property manager. Disbursements from the replacement fund generally may be made only for designated purposes.

Interest earned. The board's policy is to allocate to each fund interest earned on all cash accounts net of income taxes.

Recognition of assets and depreciation policy. The association recognizes personal property assets at cost. The property is depreciated over its estimated useful life using the straight-line method of depreciation.

3. Owners' Assessments

Monthly assessments to owners were $103.54 and $94.69 in 20X7 and 20X6. Of those amounts, $25.73 and $22.50 were designated to the replacement fund.

The annual budget and assessments of owners are determined by the board of directors and are approved by the owners. The association retains excess operating funds at the end of the operating year, if any, for use in future operating periods.

4. Future Major Repairs and Replacements

Alternative A. The association's governing documents require that funds be accumulated for future major repairs and replacements. Accumulated funds are held in separate savings accounts and generally are not available for expenditures for normal operations.

The board of directors conducted a study in November 20X7 to estimate the remaining useful lives and the replacement costs of the components of common property. The estimates were obtained from licensed contractors who inspected the property. The table included in the unaudited supplementary information on Future Major Repairs and Replacements is based on the study.

The board is funding for major repairs and replacements over the remaining useful lives of the components based on the study's estimates of current replacement costs and considering amounts previously accumulated in the replacement fund. Accordingly, the funding requirement of $302,000, based on a full funding plan, has been included in the 20X8 budget.

Funds are being accumulated in the replacement fund based on estimates of future needs for repairs and replacements of common property components. Actual expenditures may vary from the estimated future expenditures, and the variations may be material. Therefore, amounts accumulated in the replacement fund may not be adequate to meet all future needs for major repairs and replacements. If additional funds are needed, the association has the right, subject to membership approval, to increase regular assessments, pass special assessments, or delay major repairs and replacements until funds are available.

The association used $30,000 from the replacement fund for operations during 20X7. The board intends to repay $20,000 of that amount during 20X8 and has, therefore, reflected $20,000 as an interfund receivable and payable. The board does not intend to repay $10,000 of the amount and has, therefore, reflected $10,000 as a transfer from the replacement to the operating fund.

Alternative B. The association's governing documents require that funds be accumulated for future major repairs and replacements. Accumulated funds are held in separate savings accounts and are generally not available for expenditures for normal operations.

The ABC Consulting Company conducted a study in November 20X7 to estimate the remaining useful lives and the replacement costs of the components of common property. The estimates were based on future estimated replacement costs. Funding requirements consider an annual inflation rate of 5 percent and interest of 8 percent, net of taxes, on amounts funded for future major repairs and replacements. The table included in the unaudited supplementary information on Future Major Repairs and Replacements is based on the study.

The board is funding for major repairs and replacements over the remaining useful lives of the components based on the study's estimates of future replacement costs and considering amounts previously accumulated in the replacement fund. Accordingly, the funding requirement of $374,000, based on a threshold funding plan, has been included in the 20X8 budget.

Funds are being accumulated in the replacement fund based on estimated future costs for repairs and replacements of common property components. Actual expenditures and investment income may vary from the estimated amounts, and the variations may be material. Therefore, amounts accumulated in the replacement fund may not be adequate to meet all future needs for major repairs and replacements. If additional funds are needed, the association has the right, subject to membership approval, to increase regular assessments, pass special assessments, or delay major repairs and replacements until funds are available.

The association used $30,000 from the replacement fund for operations during 20X7. The board intends to repay $20,000 of that amount during 20X7 and has, therefore, reflected $20,000 as an interfund receivable and payable. The board does not intend to repay $10,000 of the amount and has, therefore, reflected $10,000 as a transfer from the replacement to the operating fund.

5. Federal and State Taxes

In 20X7, the association filed its income tax return, Form 1120, as a regular corporation. The association had an excess of expenses for the maintenance of the common property over membership source income. That excess may be carried over to future periods to offset future income from membership sources when the association files as a regular corporation. In 20X6, the association elected to file as a homeowners' association in accordance with Internal Revenue Code 528, using Form 1120-H. Under that section, the association excludes from taxation exempt function income, which generally consists of revenue from uniform assessments to owners. In both years, the association's investment income and other nonexempt income were subject to tax.

6. Lawsuit Settlements

During 20X1, the association settled a lawsuit against the developer for defective construction and received a partial settlement of $91,000. During 20X7, the association received another settlement of $141,000. Legal fees of $10,000 were incurred in connection with that lawsuit.

The following net amounts have been added to the replacement fund:

	20X7	*20X6*
Roof	$131,000	$66,000
Tennis courts	0	23,000
Pools and spas	0	1,000
Streets	0	1,000
TOTAL	$131,000	$91,000

7. Assessments Receivable

The association's policy is to retain legal counsel and place liens on the properties of homeowners whose assessments are 30 days in arrears and therefore considered delinquent. As of December 31, 20X7, the association had assessments receivable of $28,000, of which $22,000 were delinquent. As of February 12, 20X8, judgments and settlements of approximately $15,000 have been received. It is the opinion of the board of directors that the association will ultimately prevail against the remaining homeowners whose assessments are delinquent, and, accordingly, no allowance for uncollectible accounts is deemed necessary.

Exhibit A-6

XYZ Condominium Association, Inc.
Schedules of Operating Fund Revenues and Expenses[3]
for the Years Ended December 31, 20X7 and 20X6

	20X7		*20X6*	
	20X7 Actual	*20X7 Budget (Unaudited)*	*20X6 Actual*	*20X6 Budget (Unaudited)*
REVENUES				
Assessments	$ 747,000	$ 747,000	$ 693,000	$ 693,000
Other charges	22,000	23,000	20,000	20,000
TOTAL	769,000	770,000	713,000	713,000
EXPENSES				
Wages and Benefits				
Grounds	130,000	144,000	106,000	128,000
Maintenance	87,000	100,000	98,000	100,000
Payroll taxes and benefits	37,000	31,000	31,000	30,000
Office	27,000	31,000	34,000	35,000
Workers' compensation insurance	13,000	16,000	15,000	15,000
	294,000	322,000	284,000	308,000
Utilities				
Electricity	111,000	108,000	100,000	95,000
Water	29,000	33,000	33,000	33,000
Gas	20,000	9,000	8,000	12,000
	160,000	150,000	141,000	140,000
Service and Contracts				
Security	43,000	45,000	45,000	50,000
Cable T.V.	21,000	20,000	19,000	20,000
Trash disposal	19,000	19,000	18,000	20,000
Pool service	18,000	18,000	17,000	15,000
Janitorial	15,000	21,000	21,000	20,000
Pest control	13,000	14,000	14,000	10,000
	129,000	137,000	134,000	135,000

[3] *Note:* Paragraph 7.90 of this guide discusses the auditor's reporting responsibility with respect to such information.

XYZ Condominium Association, Inc.
Schedules of Operating Fund Revenues and Expenses
for the Years Ended December 31, 20X7 and 20X6—continued

	20X7		*20X6*	
	20X7 Actual (Unaudited)	*20X7 Budget (Unaudited)*	*20X6 Actual (Unaudited)*	*20X6 Budget (Unaudited)*
Repairs and Supplies				
Landscape supplies	15,000	11,000	9,000	10,000
Equipment repairs	14,000	11,000	13,000	12,000
Equipment rental	13,000	13,000	8,000	7,000
Vehicle maintenance	12,000	14,000	7,000	10,000
Fence repairs	8,000	8,000	8,000	7,000
Plumbing	6,000	5,000	5,000	8,000
Street repairs	5,000	2,000	2,000	6,000
Parts and supplies	5,000	2,000	2,000	1,000
Pool repairs	4,000	5,000	1,000	2,000
Sprinkler supplies	4,000	7,000	3,000	2,000
Electrical	3,000	3,000	2,000	3,000
Tennis courts	3,000	2,000	1,000	2,000
	92,000	83,000	61,000	70,000
Insurance and Licenses				
Insurance	49,000	49,000	45,000	40,000
Licenses	1,000	1,000	1,000	
	50,000	50,000	46,000	40,000
Administrative				
Accounting	11,000	10,000	6,000	7,000
Legal	9,000	11,000	8,000	8,000
Office	4,000	4,000	1,000	1,000
Telephone	4,000	3,000	3,000	4,000
	28,000	28,000	18,000	20,000
Bad Debts	2,000			
Depreciation	3,000		3,000	
Income Taxes	1,000			
TOTAL EXPENSES	759,000	770,000	687,000	713,000
EXCESS OF REVENUES OVER EXPENSES	$ 10,000	$	$ 26,000	$

Exhibit A-7

XYZ Condominium Association, Inc.
Schedules of Changes in Replacement Fund Balances
for the Years Ended December 31, 20X7 and 20X6

	20X7			
COMMON AREA COMPONENT	*Beginning Fund Balance*	*Additions to Fund*[4]	*Charges to Fund*	*Components of Ending Fund Balance*
Roofs	$ 96,000	$ 202,000	$ 144,000	$ 154,000
Streets	17,000	44,000	4,000	57,000
Recreation facilities	50,000	10,000	5,000	55,000
Exterior siding	38,000	104,000	94,000	48,000
Pools, spas, solar equipment	8,000	36,000	5,000	39,000
Tennis courts	4,000	10,000		14,000
Furniture and equipment	12,000			12,000
Lawsuit legal fees		10,000	10,000	
TOTAL	$ 225,000	$ 416,000	$ 262,000	$ 379,000

	20X5			
COMMON AREA COMPONENT	*Beginning Fund Balance*	*Additions to Fund*[4]	*Charges to Fund*	*Components of Ending Fund Balance*
Roofs	$ 102,000	$ 154,000	$ 160,000	$ 96,000
Streets	11,000	26,000	20,000	17,000
Recreation facilities	35,000	17,000	2,000	50,000
Exterior siding	32,000	104,000	98,000	38,000
Pools, spas, solar equipment	13,000	13,000	18,000	8,000
Tennis courts	2,000	14,000	12,000	4,000
Furniture and equipment		12,000		12,000
TOTAL	$ 195,000	$ 340,000	$ 310,000	$ 225,000

[4] Includes interest income of $49,000, net of income taxes of $11,000 and net of a $10,000 transfer to the operating fund in 20X7 and interest income of $46,000 net of income taxes of $13,000 in 20X6.

Note: These reconciling items may be presented as illustrated here or in separate columns in this schedule.

Exhibit A-8

XYZ Condominium Association, Inc.
Supplementary Information on Future Major Repairs and Replacements December 31, 20X7
(Unaudited)

Alternative A. The board of directors conducted a study in November 20X7 to estimate the remaining useful lives and the replacement costs of the components of common property. The estimates were obtained from licensed contractors who inspected the property.

The following table is based on the study and presents significant information about the components of common property.

Components	*Estimated Remaining Useful Lives (Years)*	*Estimated Current Replacement Costs*	*20X8 Funding Requirement*	*Components of Fund Balance at Dec. 31, 20X7*
Roofs	5 to 14	$ 1,620,000	$120,000	$ 154,000
Streets	5 to 14	96,000	40,000	57,000
Recreation facilities	2 to 11	120,000	12,000	55,000
Exterior siding	7–11	760,000	72,000	48,000
Pools, spas, solar equipment	2–14	112,000	36,000	39,000
Tennis courts	5–10	64,000	10,000	14,000
Furniture and equipment	3–7	80,000	12,000	12,000
		$ 2,852,000	$ 302,000	$ 379,000

(continued)

**XYZ Condominium Association, Inc.
Supplementary Information on Future Major
Repairs and Replacements December 31, 20X7
(Unaudited)—continued**

Alternative B. The ABC Consulting Company conducted a study in November 20X7 to estimate the remaining useful lives and the replacement costs of the components of common property. The estimates were based on future estimated replacement costs. Funding requirements consider an annual inflation rate of 5 percent and interest of 8 percent, net of taxes, on amounts funded for future major repairs and replacements.

The following table is based on the study and presents significant information about the components of common property.

Components	*Estimated Remaining Useful Lives (Years)*	*Estimated Current Replacement Costs*	*20X8 Funding Requirement*	*Components of Fund Balance at Dec. 31, 20X7*
Roofs	5 to 14	$ 3,023,000	$152,000	$154,000
Streets	5 to 14	179,000	46,000	57,000
Recreation facilities	2 to 11	180,000	15,000	55,000
Exterior siding	7 to 11	1,256,000	93,000	48,000
Pools, spas, solar equipment	2 to 14	174,000	42,000	39,000
Tennis courts	5 to 10	97,000	12,000	14,000
Furniture and equipment	3 to 7	107,000	14,000	12,000
		$ 5,016,000	$374,000	$379,000

Exhibit A-9

XYZ Homeowners' Association, Inc.
Balance Sheets
as of December 31, 20X7 and 20X6

ASSETS

	20X7	*20X6*
Cash	$ 110,000	$68,000
Cash for future major repairs and replacements	64,000	30,000
Certificates of deposit for future major repairs and replacements	300,000	200,000
Member assessments receivable	28,000	9,000
Prepaid expenses	7,000	7,000
Manager's dwelling (net of accumulated depreciation of $20,000 and $10,000)	200,000	210,000
Equipment (net of accumulated depreciation of $8,000 and $5,000)	21,000	17,000
TOTAL ASSETS	$ 730,000	$ 541,000

LIABILITIES AND MEMBERS' EQUITY

Accounts payable	$24,000	$6,000
Wages payable	6,000	
Income taxes payable	1,000	5,000
Prepaid assessments	20,000	15,000
TOTAL LIABILITIES	51,000	26,000
MEMBERS' EQUITY	679,000	515,000
TOTAL LIABILITIES AND MEMBERS' EQUITY	$ 730,000	$ 541,000

The accompanying notes are an integral part of the financial statements.

Exhibit A-10

XYZ Homeowners' Association, Inc.
Statements of Revenues and Expenses
for the years Ended December 31, 20X7 and 20X6

	20X7	*20X6*
REVENUES		
Member assessments:		
Operations	$ 747,000	$ 693,000
Future major repairs and replacements	247,000	216,000
Lawsuit settlements	141,000	91,000
Interest	49,000	46,000
Other charges	22,000	20,000
TOTAL REVENUES	1,206,000	1,066,000
EXPENSES		
Wages and benefits	294,000	284,000
Major repairs and replacements[5]	262,000	310,000
Utilities	160,000	141,000
Services and contracts	129,000	134,000
Repairs and supplies	92,000	61,000
Insurance and licenses	50,000	46,000
Administrative	28,000	18,000
Depreciation	13,000	13,000
Income taxes	12,000	13,000
Bad debts	2,000	
TOTAL EXPENSES	1,042,000	1,020,000
EXCESS OF REVENUES OVER EXPENSES	$ 164,000	$ 46,000

The accompanying notes are an integral part of the financial statements.

[5] Expenditures for major repairs and replacements may be presented as 1 amount, listed separately in this statement, or listed in an accompanying schedule as illustrated in exhibit A-13.

Exhibit A-11

Direct Method

XYZ Homeowners' Association, Inc.
Statements of Cash Flows
for the Years Ended December 31, 20X7 and 20X6
Increase (Decrease) in Cash and Cash Equivalents

	20X7	*20X6*
Cash flows from operating activities:		
Member assessments collected:		
For operations	$ 733,000	$ 704,000
For future major repairs and replacements	247,000	216,000
Lawsuit settlement	141,000	91,000
Interest received	49,000	46,000
Other income received	22,000	20,000
Administrative expenses	(30,000)	(21,000)
Utilities	(160,000)	(143,000)
Services and contracts	(111,000)	(125,000)
Income taxes	(16,000)	(12,000)
Insurance and licenses	(50,000)	(50,000)
Repairs and supplies	(92,000)	(64,000)
Wages and benefits	(288,000)	(284,000)
Expenditures for major repairs and replacements	(262,000)	(310,000)
Net cash provided by operating activities	183,000	68,000
Net cash flows from investing activities:		
Purchase of equipment	(7,000)	(3,000)
Net increase in cash and cash equivalents	176,000	65,000
Cash and cash equivalents at beginning of year	298,000	233,000
Cash and cash equivalents at end of year	$ 474,000	$ 298,000
ANALYSIS OF CASH		
Cash in bank-operating account	$ 110,000	$ 68,000
Cash-designated for future major repairs and replacements	364,000	230,000
TOTAL CASH	$ 474,000	$ 298,000

(continued)

The accompanying notes are an integral part of the financial statements.

XYZ Homeowners' Association, Inc.
Statements of Cash Flows
for the Years Ended December 31, 20X7 and 20X6
Increase (Decrease) in Cash and Cash Equivalents—continued

	20X7	*20X6*
Reconciliation of excess of revenues over expenses to net cash provided by operating activities:		
Excess of revenues over expenses	$ 164,000	$ 46,000
Adjustments to reconcile excess of revenues over expenses to net cash provided by operating activities:		
Depreciation	13,000	13,000
(Increase) Decrease in member assessments receivable	(19,000)	8,000
Increase in accounts payable	18,000	6,000
Increase in wages payable	6,000	5,000
(Decrease) in income taxes payable	(4,000)	(10,000)
Increase in prepaid assessments	5,000	
Net cash provided by operating activities	$ 183,000	$ 68,000

The accompanying notes are an integral part of the financial statements.

Exhibit A-12

XYZ Homeowners' Association, Inc.
Statements of Changes in Members' Equity
for the Years Ended December 31, 20X7 and 20X6

	20X7			
	Future Major Repairs and Replacements	*Members' Initial Capital Contributions*[6]	*Retained Earnings (Deficit)*	*Total Members' Equity*
MEMBERS' EQUITY-BEGINNING OF YEAR	$ 225,000	$ 265,000	$ 25,000	$ 515,000
Excess of revenues over expenses			164,000	164,000
Amounts allocated to major repairs and replacements[7]	164,000		(164,000)	
Transfer from future major repairs and replacements to retained earnings	(10,000)		10,000	
MEMBERS' EQUITY-END OF YEAR	$ 379,000	$ 265,000	$ 35,000	$ 679,000

(continued)

The accompanying notes are an integral part of the financial statements.

[6] If this column is used, the following note is added to the financial statements:
Members' initial capital contributions. At the time of closing by initial owners, one month's assessment was contributed to the association to provide additional working capital.

[7] Consisting of assessments for future major repairs and replacements, lawsuit settlements, and interest less income taxes, net of expenditures for major repairs and replacements. [*Note:* This amount does not necessarily equal excess of revenues over expenses.] As an alternative presentation, the components of this amount could be summarized in the notes to the financial statements and the Future Major Repairs and Replacements column could be omitted.

XYZ Homeowners' Association, Inc.
Statements of Changes in Members' Equity
for the Years Ended December 31, 20X7 and 20X6—continued

	20X7			
	Future Major Repairs and Replacements	*Members' Initial Capital Contributions*[8]	*Retained Earnings (Deficit)*	*Total Members' Equity*
MEMBERS' EQUITY-BEGINNING OF YEAR	$ 195,000	$ 265,000	$ 9,000	$ 469,000
Excess of revenues over expenses			46,000	46,000
Amounts allocated to major repairs and replacements[9]	30,000		(30,000)	
MEMBERS' EQUITY-END OF YEAR	$ 225,000	$ 265,000	$ 25,000	$ 515,000

The accompanying notes are an integral part of the financial statements.

[8] If this column is used, the following note is added to the financial statements:
Members' initial capital contributions. At the time of closing by initial owners, one month's assessment was contributed to the association to provide additional working capital.

[9] Consisting of assessments for future major repairs and replacements, lawsuit settlements, and interest less income taxes, net of expenditures for major repairs and replacements.

Exhibit A-13

XYZ Homeowners' Association, Inc.
Schedules of Expenses
for Major Repairs and Replacements
for the Years Ended December 31, 20X7 and 20X6

	20X7	*20X6*
Roofs	$ 144,000	$ 160,000
Exterior siding	94,000	98,000
Legal fees	10,000	
Recreation	5,000	2,000
Solar equipment	5,000	
Streets	4,000	20,000
Pools and spas		18,000
Tennis courts		12,000
TOTAL	$ 262,000	$ 310,000

Exhibit A-14

ABC Cooperative, Inc.[10]
(A Cooperative Housing Corporation)
Balance Sheet
December 31, 20X7

ASSETS

Cash including investment in money market fund of $6,850		$ 38,000
Tenant-shareholders' rent receivables		15,000
Prepaid expenses		9,000
Property and equipment		
Land	$ 640,000	
Building	1,720,000	
Building improvements: construction in progress	140,000	
Furniture and equipment	90,000	
	2,590,000	
Less: accumulated depreciation	1,620,000	
Net property		970,000
Mortgage refinancing costs, less accumulated amortization of $15,000		25,000
TOTAL ASSETS		$ 1,057,000

LIABILITIES AND SHAREHOLDERS' EQUITY (DEFICIT)

Accounts payable and accrued expenses		$ 118,000
Prepaid rents		6,000
Mortgage note payable		1,865,000
Security deposits of commercial lessees		8,000
TOTAL LIABILITIES		1,997,000
Shareholders' equity (deficit)		
Common stock $2.00 par value; authorized 40,000 shares, issued and outstanding 20,000 shares	$ 40,000	
Additional paid-in-capital	420,000	
	460,000	
Deficit	(1,400,000)	
Total shareholders' equity (deficit):		(940,000)
TOTAL LIABILITIES AND SHAREHOLDERS' DEFICIT		$ 1,057,000

The accompanying notes are an integral part of the financial statements.

[10] If separate funds are maintained for future major repairs and replacements or for other purposes, fund reporting may be more informative to users of the financial statements of cooperative housing corporations and may be used as an alternative presentation.

Exhibit A-15

ABC Cooperative, Inc.
(A Cooperative Housing Corporation)
Statement of Revenues, Expenses, and Deficit
Year Ended December 31, 20X7

REVENUES		
Carrying charges		$ 700,000
Commercial rent		89,000
Appliance and air-conditioning charges		45,000
Interest		10,000
Resale fees		3,000
Forfeited security deposits		2,000
TOTAL REVENUES		849,000
EXPENSES		
Wages including fringe benefits	$ 295,000	
Real estate taxes	237,000	
Interest	195,000	
Utilities	121,000	
Repairs and maintenance	53,000	
Management fees	24,000	
Insurance	16,000	
Legal and accounting	10,000	
Security	4,000	
Income taxes	2,000	
TOTAL EXPENSES BEFORE DEPRECIATION AND AMORTIZATION		957,000
Deficiency of revenues over expenses before depreciation		(108,000)
Depreciation		72,000
Deficiency of revenues over expenses		(180,000)
Deficit-beginning of year		(1,220,000)
DEFICIT-END OF YEAR		$ (1,400,000)

The accompanying notes are an integral part of the financial statements.

Exhibit A-16

Direct Method

ABC Cooperative, Inc.
(A Cooperative Housing Corporation)
Statement of Cash Flows
Year Ended December 31, 20X7

Cash flows from operating activities:	
Tenant-shareholder carrying charges, net of $60,000 allocated to financing activities	$ 640,000
Commercial rent	89,000
Appliance and air-conditioning charges and resale fees	48,000
Interest income	10,000
Forfeited security deposits	2,000
Cash paid to employees and suppliers	(437,000)
Real estate taxes	(292,000)
Interest expense	(140,000)
Net cash absorbed by operating activities	(80,000)
Cash flows from financing activities:	
Tenant-shareholder carrying charges	60,000
Repayment of debt	(60,000)
Net cash from financing activities	0
Cash flows from investing activities:	
Additions to building, furniture and equipment	(150,000)
Net decrease in cash and cash equivalents	(230,000)
Cash and cash equivalents:	
Beginning of period	268,000
End of period	$ 38,000

The accompanying notes are an integral part of the financial statements.

ABC Cooperative, Inc.
(A Cooperative Housing Corporation)
Statement of Cash Flows
Year Ended December 31, 20X7—continued

Reconciliation of deficiency of revenues over expenses to net cash absorbed by operating activities:	
Deficiency of revenues over expenses	$ (180,000)
Adjustments to reconcile deficiency of revenues over expenses to net cash absorbed by operating activities:	
Revenue allocated to financing activities	(60,000)
Depreciation	72,000
(Increase) in tenant-shareholder rent receivables	(2,000)
Decrease in prepaid expenses	3,000
Increase in accounts payable and accrued expenses	85,000
Increase in prepaid rents	3,000
(Decrease) in security deposits of commercial leases	(1,000)
Net cash absorbed by operating activities	$ (80,000)

The accompanying notes are an integral part of the financial statements.

Exhibit A-17

ABC Cooperative, Inc.
(A Cooperative Housing Corporation)
Notes to Financial Statements
December 31, 20X7

1. Organization

ABC Cooperative, Inc., a cooperative housing corporation, was incorporated in the state of New York in April, 20XX. The corporation owns the 18-story building known as ABC Apartments located at ____________ in New York City and consisting of 175 residential apartments and 10 commercial units.

2. Summary of Significant Accounting Policies

Pervasiveness of Estimates. The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Property and equipment. Property and equipment are stated at cost. Depreciation is computed on the straight-line basis, based on a 30-year life for the building and a 10-year life for building improvements, furniture, and equipment.

Mortgage refinancing costs. Mortgage refinancing costs are amortized by the interest method over the 10-year term of the loan.

3. Revenue

Carrying charges. Carrying charges are based on an annual budget determined by the board of directors. Tenant-shareholders are billed monthly based on their respective stock holdings. The corporation retains excess operating funds, if any, at the end of the operating year, for use in future operating periods.

Commercial rent. The corporation has entered into 5-year lease agreements with 10 commercial tenants providing for annual rentals aggregating $92,000 with increases based on the Consumer Price Index.

4. Mortgage Note Payable

The corporation has a mortgage note payable, secured by the land and building, to XYZ Bank of New York with interest at the rate of 10 percent. The aggregate amount of required principal payments at December 31, 20X7, is as follows:

20X7	$ 61,000
20X8	62,000
20X9	63,000
20X0	65,000
20X1	67,000
later years	1,547,000
Total	$1,865,000

5. Federal and State Taxes

The cooperative pays federal taxes on net income from patronage and nonpatronage income in accordance with Subchapter T. Income tax expense in 20X7 was $2,000.

6. Future Major Repairs and Replacements

The corporation's governing documents require that funds be accumulated for future major repairs and replacements. The corporation has not accumulated those funds. When those funds are needed, the corporation plans to borrow, increase carrying charges, or delay repairs and replacements until funds are available.[11]

The board of directors conducted a study in November 20X7 to estimate the remaining useful lives and the replacement costs of the components of common property. The estimates were obtained from licensed contractors who inspected the property. The table included in the unaudited supplementary information on Future Major Repairs and Replacements is based on the study.

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[11] Many co-ops have no corporate requirement for reserves; some have a requirement as a condition of a loan. Some states have statutes dealing with reserves, most are vague, but not all. For instance Florida has the opt-out provision for reserves and Hawaii has specific language and examples that address the calculation of reserve fund status.

Exhibit A-18

ABC Cooperative, Inc.
(A Cooperative Housing Corporation)
Supplementary Information on Future Major Repairs and Replacements
December 31, 20X7
(Unaudited)

In November, 20X7, the board of directors conducted a study to estimate the remaining useful lives and the replacement costs of the components of the building, furniture, and equipment. The estimates were obtained from licensed contractors who inspected the property. The following table is based on that study and presents significant information about the components of the building, furniture, and equipment.

Components	*Estimated Remaining Useful Lives (Years)*	*Estimated Current Replacement Costs*
Roof	15	$ 175,000
Exterior	3	30,000
Recreation Facilities	2-5	25,000
Carpeting	5	45,000
Furniture and equipment	2-7	15,000
		$ 290,000

Appendix B

Illustrative Engagement and Representation Letters

Exhibit B-1

Illustrative Engagement Letter—Audit

[*Date*]

XYZ Condominium Association
12345 Slowhand Road
Highprice, Illinois 00000

Dear _______________ :

This will confirm our understanding of the arrangement for our audit of the financial statements of XYZ Condominium Association for the year ending December 31, 20X7.

We will audit the Association's balance sheet at December 31, 20X7, and the related statements of revenues, expenses, and changes in fund balances and cash flows for the year then ended, for the purpose of expressing an opinion on them. The financial statements are the responsibility of the Association's management. Management is responsible for establishing and maintaining effective internal control over financial reporting, making financial records and related information available for audit, and for identifying and ensuring that the Association complies with the laws and regulations that apply to its activities. Management also is responsible for adjusting the financial statements to correct material misstatements and for affirming to us in the representation letter that the effects of any uncorrected misstatements aggregated by us during the current engagement and pertaining to the latest period presented are immaterial, both individually and in the aggregate, to the financial statements taken as a whole.

We will conduct our audit in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable rather than absolute assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud. Accordingly, a material misstatement may remain undetected. Also, an audit is not designed to detect error or fraud that is immaterial to the financial statements. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit will provide a reasonable basis for our opinion.

We will not determine whether the reserve balances are adequate to meet future repair and replacement costs because such a determination is outside the scope of the engagement.

The audit includes obtaining an understanding of internal control sufficient to plan the audit and to determine the nature, timing, and extent of audit procedures to be performed. An audit is not designed to provide assurance on internal control or to identify reportable conditions. However, we are responsible for ensuring that management of the Association is aware of any reportable conditions which come to our attention. If, for any reason, we are unable to complete the audit or are unable to form or have not formed an opinion, we may decline to express an opinion or decline to issue a report as a result of the engagement.

Our procedures will include tests of documentary evidence supporting the transactions recorded in the accounts, and direct confirmation of receivables and certain other assets and liabilities by correspondence with selected owners, creditors, legal counsel, and banks. At the conclusion of our audit, management will provide us with a letter that confirms certain written representations made during the audit.

We will review the Association's federal and state income tax returns for the fiscal year ended December 31, 20X7. These returns, we understand, will be prepared by the controller.

Furthermore, we will be available during the year to consult with you on the tax effects of any proposed transactions or contemplated changes in business policies.

Our fee for these services will be at our regular per diem rates, plus travel and other out-of-pocket costs. Invoices will be rendered every two weeks and are payable on presentation.

The cost of printing copies of the annual report to be distributed to unit owners and other expenses we incur on behalf of the Association will be added to our service charges. Our invoices are payable on submission.

If this letter correctly expresses your understanding, please sign the enclosed copy where indicated and return it to us.

Very truly yours,

Certified Public Accountants

XYZ CONDOMINIUM ASSOCIATION

By _______________

Date _______________

Exhibit B-2

Illustrative Engagement Letter—Review[*]

[*Date*]

XYZ Homeowners' Association, Inc.
12345 Slowhand Road
Highprice, Illinois 00000

Re: XYZ HOMEOWNERS' ASSOCIATION, INC.

Dear _______________ :

This letter is to confirm our understanding of the terms and objectives of our engagement and the nature and limitations of the services we will provide.

We will perform the following services:

We will review the financial statements of XYZ Homeowners' Association as of December 31, 20X7, and issue an accountant's report thereon in accordance with Statements on Standards for Accounting and Review Services issued by the AICPA. We will not perform an audit of such financial statements, the objective of which is the expression of an opinion regarding the financial statements taken as a whole, and, accordingly, we will not express such an opinion on them.

A review consists primarily of inquiries of Association personnel and analytical procedures applied to financial data. A review does not contemplate obtaining an understanding of internal control or assessing control risk, tests of accounting records and responses to inquiries by obtaining corroborating evidential matter, and certain other procedures ordinarily performed during an audit. Thus, a review does not provide assurance that we will become aware of all significant matters that would be disclosed in an audit.

Our engagement cannot be relied upon to disclose errors, fraud, or illegal acts that may exist. However, we will inform the appropriate level of management of any material errors, and of any evidence or information that comes to our attention during the performance of our review procedures, that fraud may have occurred. In addition, we will report to you any evidence or information that comes to our attention during the performance of our review procedures regarding illegal acts that may have occurred, unless they are clearly inconsequential.

As part of our engagement, we will also [*list any nonattest services to be provided, if applicable, such as income tax preparation and bookkeeping services as presented in the following example*]

1. Prepare the federal and state income tax returns for XYZ Homeowners' Association for the fiscal year ended December 31, 20X7.

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[*] On February 13, 2008, the Accounting and Review Services Committee issued Statement on Standards for Accounting and Review Services (SSARS) No. 17, *Omnibus Statement on Standards for Accounting and Review Services—2008* (AICPA, *Professional Standards*, vol. 2), which is effective for compilations and reviews of financial statements for periods ending on or after December 15, 2008; early application is permitted. For review engagements to which this statement applies, refer to SSARS No. 17 for the changes applicable to engagement letters for review engagements.

2. Provide your chief accountant with such consultation on accounting matters as may be required in adjusting and closing the books of account and in drafting financial statements for our review (your chief accountant will provide us with a detailed trial balance and any supporting schedules we require).

You are responsible for:

(a) Making all management decisions and performing all management functions;

(b) Designating an individual who possesses suitable skill, knowledge, or experience, or both, preferably within senior management, to oversee the services;

(c) Evaluating the adequacy and results of the services performed;

(d) Accepting responsibility for the results of the services; and

(e) Establishing and maintaining internal controls, including monitoring ongoing activities.

As part of our review procedures, we will require certain written representations from management about the financial statements and matters related thereto.

If, for any reason, we are unable to complete our review of your financial statements, we will not issue a report on such statements as a result of this engagement.

We estimate our fees for these services to be $________ plus out-of-pocket costs. We will make progress billings during the engagement, payable on receipt.

We will be pleased to discuss this letter with you at any time.

If the foregoing is in accordance with your understanding, please sign the copy of this letter in the space provided and return it to us.

Sincerely,
Certified Public Accountants

[*Signature of the accountant*]

Accepted by: ________________

Title: ________________

Date: ________________

Exhibit B-3

Illustrative Engagement Letter—Compilation†

[*Date*]

XYZ Homeowners' Association, Inc.
12345 Slowhand Road
Highprice, Illinois 00000

Re: XYZ HOMEOWNERS' ASSOCIATION, INC.

Dear _______________ :

This letter is to confirm our understanding of the terms and objectives of our engagement and the nature and limitations of the services we will provide.

We will perform the following services:

We will compile, from information you provide, the annual balance sheets and related statements of revenues and expenses and changes in fund balances, and cash flows of XYZ Homeowners' Association for the year 20X7.

We will compile the financial statements and issue an accountant's report thereon in accordance with Statements on Standards for Accounting and Review Services issued by the AICPA. A compilation is limited to presenting, in the form of financial statements, information that is the representation of management. We will not audit or review the financial statements and, accordingly, will not express an opinion or any other form of assurance on them.

Our engagement cannot be relied upon to disclose errors, fraud, or illegal acts that may exist. However, we will inform the appropriate level of management of any material errors, and of any evidence or information that comes to our attention during the performance of our compilation procedures, that fraud may have occurred. In addition, we will report to you any evidence or information that comes to our attention during the performance of our compilation procedures regarding illegal acts that may have occurred, unless they are clearly inconsequential.

As part of our engagement, we will also [*list any nonattest services to be performed, if applicable, such as income tax preparation and bookkeeping services as presented in the following example*]

1. Prepare the federal and state income tax returns for XYZ Homeowners' Association for the fiscal year ended December 31, 20X7.
2. Assist your bookkeeper in adjusting the books of account so that he or she will be able to prepare a working trial balance from which the financial statements can be compiled (your bookkeeper will provide us with a detailed trial balance and any supporting schedules we require).

† Practitioners engaged to compile financial statements not intended for third party use can find an illustrative engagement letter included in appendix D of AR section 100, *Compilation and Review of Financial Statements* (AICPA, *Professional Standards*, vol. 2). For compilation engagements to which SSARS No. 17 applies, refer to SSARS No. 17 for the changes applicable to engagement letters for compilation engagements.

You are responsible for:

(a) Making all management decisions and performing all management functions;

(b) Designating an individual who possesses suitable skill, knowledge, or experience, or both, preferably within senior management, to oversee the services;

(c) Evaluating the adequacy and results of the services performed;

(d) Accepting responsibility for the results of the services; and

(e) Establishing and maintaining internal controls, including monitoring ongoing activities.

Material departures from generally accepted accounting principles (GAAP) may exist, and the effects of those departures, if any, on the financial statements may not be disclosed. [*The following sentence is applicable if the CIRA omits substantially all disclosures*.] In addition substantially all disclosures required by GAAP may be omitted. (The accountant may wish to identify known departures.)

If, for any reason, we are unable to complete the compilation of your financial statements, we will not issue a report on such statements as a result of this engagement.

We estimate our fees for these services to be $________plus out-of-pocket costs. We will make progress billings during the engagement, payable on receipt.

We will be pleased to discuss this letter with you at any time.

If the foregoing is in accordance with your understanding, please sign the copy of this letter in the space provided and return it to us.[‡]

Sincerely,

Certified Public Accountants

[*Signature of the accountant*]

Accepted by: ______________

Title: ______________

Date: ______________

[‡] Some accountants prefer not to obtain an acknowledgment, in which case their letter would omit the paragraph beginning, "If the foregoing. . ." and the spaces for the acknowledgment. The first paragraph of their letter might begin as follows: "This letter sets forth our understanding of the terms and objectives of our engagement. . ."

Exhibit B-4

Illustrative Representation Letter—Audit

[*To be prepared on the CIRA's or managing agent's letterhead*]

[*Date*][||]

[*To the Independent Auditor*]

We are providing this letter in connection with your audit of the balance sheets and the related statements of revenues, expenses, and changes in fund balances, and cash flows of XYZ Condominium Association as of December 31, 19X7 and 19X6 for the years then ended, for the purpose of expressing an opinion as to whether the financial statements present fairly, in all material respects, the financial position, results of operations, and cash flows of XYZ Condominium Association in conformity with accounting principles generally accepted in the United States of America. We confirm that we are responsible for the fair presentation in the financial statements of financial position, results of operations, and cash flows in conformity with generally accepted accounting principles.

Certain representations in this letter are described as being limited to matters that are material. Items are considered material, regardless of size, if they involve an omission or misstatement of accounting information that, in the light of surrounding circumstances, makes it probable that the judgment of a reasonable person relying on the information would be changed or influenced by the omission or misstatement.

We confirm, to the best of our knowledge and belief, (as of [*date of auditor's report*]) the following representations made to you during your audit:

1. The financial statements referred to previously are fairly presented in conformity with accounting principles generally accepted in the United States of America.
2. We are responsible for the fair presentation of the information about future major repairs and replacements in the supplementary information accompanying the financial statements.
3. We have made available to you all—
    a. Financial records and related data.
    b. Minutes of the meetings of directors and committees of directors, or summaries of actions of recent meetings for which minutes have not yet been prepared.
4. There have been no communications from regulatory agencies concerning noncompliance with or deficiencies in financial reporting practices.
5. There are no material transactions that have not been properly recorded in the accounting records underlying the financial statements.
6. We believe that the effects of the uncorrected financial statement misstatements summarized in the accompanying schedule are immaterial, both individually and in the aggregate, to the financial statements taken as a whole.

[||] Because the auditor is concerned with events occurring through the date of the report that may require adjustment to or disclosure in the financial statements, the representations should be made as of, and the representation letter dated the same as, the date of the auditor's report.

7. We acknowledge our responsibility for the design and implementation of programs and controls to prevent and detect fraud.
8. We have no knowledge of any fraud or suspected fraud affecting the entity involving—
   a. Management,
   b. Employees who have significant roles in internal control, or
   c. Others where the fraud could have a material effect on the financial statements.
9. We have no knowledge of any allegations of fraud or suspected fraud affecting the entity received in communications from employees, former employees, or others.
10. We have no plans or intentions that may materially affect the carrying value or classification of assets and liabilities.
11. The following have been properly recorded or disclosed in the financial statements:
    a. Related party transactions, including sales, purchases, loans, transfers, leasing arrangements, and guarantees, and amounts receivable from or payable to related parties.
    b. Guarantees, whether written or oral, under which the Association is contingently liable.
    c. Significant estimates and material concentrations known to management that are required to be disclosed in accordance with the AICPA's Statement of Position 94-6, *Disclosure of Certain Significant Risks and Uncertainties* (AICPA, *Technical Practice Aids*, ACC sec. 10,640). [*Significant estimates are estimates at the balance sheet date that could change materially within the next year. Concentrations refer to volumes of business, revenues, available sources of supply, or markets or geographic areas for which events could occur that would significantly disrupt normal finances within the next year*.]
12. There are no—
    a. Violations or possible violations of laws or regulations whose effects should be considered for disclosure in the financial statements or as a basis for recording a loss contingency.
    b. Unasserted claims or assessments that our lawyer has advised us are probable of assertion and must be disclosed in accordance with Financial Accounting Standards Board (FASB) Statement No. 5, *Accounting for Contingencies*.[1]

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[1] In the circumstance discussed in footnote 11 of AU section 333, *Management Representations* (AICPA, *Professional Standards*, vol. 1), this representation might be worded as follows:

> We are not aware of any pending or threatened litigation, claims, or assessments or unasserted claims or assessments that are required to be accrued or disclosed in the financial statements in accordance with Financial Accounting Standards Board (FASB) Statement No. 5, *Accounting for Contingencies*, and we have not consulted a lawyer concerning litigation, claims, or assessments.

   c. Other liabilities or gain or loss contingencies that are required to be accrued or disclosed by FASB Statement No. 5.

13. The Association has satisfactory title to all owned assets, and there are no liens or encumbrances on such assets nor has any asset been pledged, as collateral.
14. We have complied with all aspects of contractual agreements that would have a material effect on the financial statements in the event of noncompliance.

    [*The following are additional representations that may be applicable.*]

15. The board of directors is collecting funds for major repairs and replacements in conformity with the Association's policy to fund for those needs based on a study conducted in November 19X7. The board of directors believes that the funds will adequately provide for future major repairs and replacements.
16. The board of directors has allocated the excess of the Association's revenues over its expenses during the current year to the fund for future major repairs and replacements.[2]
17. To the best of our knowledge and belief, no events have occurred subsequent to the balance-sheet date and through the date of this letter that would require adjustment to or disclosure in the aforementioned financial statements.

____
Signature and Title

____
Signature and Title

[2] The inclusion of other representations that are unique to the engagement or to the entity's business or industry should be considered by the auditor. In addition, appendix B of AU section 333 contains a list of other representations that may be appropriate in certain situations.

Exhibit B-5

Illustrative Representation Letter—Review

[*To be prepared on the CIRA's or managing agent's letterhead*]

[*Date of Accountant's Report*][#]

[*To the Accountant*]

We are providing this letter in connection with your review of the balance sheet and the related statements of revenues, expenses, and changes in fund balances, and cash flows of XYZ Condominium Association as of December 31, 20X7, and for the year then ended, for the purpose of expressing limited assurance that there are no material modifications that should be made to the statements in order for them to be in conformity with generally accepted accounting principles (GAAP). We confirm that we are responsible for the fair representation in the financial statements of financial position, results of operations, and cash flows in conformity with GAAP.

Certain representations in this letter are described as being limited to matters that are material. Items are considered material, regardless of size, if they involve an omission or misstatement of accounting information that, in the light of surrounding circumstances, makes it probable that the judgment of a reasonable person using the information would be changed or influenced by the omission or misstatement.[3]

We confirm, to the best of our knowledge and belief, (as of [a date no earlier than the date of review report, see Statements on Standards for Accounting and Review Services No. 1, *Compilation and Review of Financial Statements* (AICPA, *Professional Standards,* vol. 2, AR sec. 100 par. .29]) the following representations made to you during your review.

1. The financial statements referred to previously are fairly presented in conformity with GAAP.
2. We have made available to you all:
   - *a.* Financial records and related data.
   - *b.* Minutes of the meetings of stockholders, directors, and committees of directors, or summaries of actions of recent meetings for which minutes have not yet been prepared.
3. There are no material transactions that have not been properly recorded in the accounting records underlying the financial statements.
4. We acknowledge our responsibility to prevent and detect fraud.
5. We have no knowledge of any fraud or suspected fraud affecting the Association involving management or others where the fraud could have a material effect on the financial statements, including

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[#] Because the accountant is concerned with events occurring through the date of the report that may require adjustment to or disclosure in the financial statements, the representations should be made as of a date no earlier than the date of the accountant's report.

For review engagements to which SSARS No. 17 applies, management's representations set forth in the management representation letter should be made as of the date of the accountant's review report.

[3] The qualitative discussion of materiality used in this letter is adapted from FASB Statement of Financial Accounting Concepts No. 2, *Qualitative Characteristics of Accounting Information.*

any communications received from employees, former employees or others.

6. We have no plans or intentions that may materially affect the carrying amounts or classification of assets and liabilities.
7. There are no material losses (such as from purchase or sales commitments) that have not been properly accrued or disclosed in the financial statements.
8. There are no:
   a. Violations or possible violations of laws or regulations, whose effects should be considered for disclosure in the financial statements or as a basis for recording a loss contingency.
   b. Unasserted claims or assessments that our lawyer has advised us are probable of assertion that must be disclosed in accordance with Financial Accounting Standards Board (FASB) Statement No. 5, *Accounting for Contingencies*.[4]
   c. Other material liabilities or gain or loss contingencies that are required to be accrued or disclosed by FASB Statement No. 5.
9. The Association has satisfactory title to all owned assets, and there are no liens or encumbrances on such assets nor has any asset been pledged as collateral, except as disclosed to you and reported in the financial statements.
10. We have complied with all aspects of contractual agreements that would have a material effect on the financial statements in the event of noncompliance.
11. The following have been properly recorded or disclosed in the financial statements:
    a. Related party transactions, including sales, purchases, loans, transfers, leasing arrangements, and guarantees, and amounts receivable from or payable to related parties.
    b. Guarantees, whether written or oral, under which the Association is contingently liable.
    c. Significant estimates and material concentrations known to management that are required to be disclosed in accordance with the AICPA's Statement of Position 94-6, *Disclosure of Certain Significant Risks and Uncertainties* (AICPA, *Technical Practice Aids*, ACC sec. 10,640). (Significant estimates are estimates at the balance sheet date that could change materially within the next year. Concentrations refer to volumes of business, revenues, available sources of supply, or markets for which events could occur that would significantly disrupt normal finances within the next year.)

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[4] If management has not consulted a lawyer regarding litigation, claims, and assessments, the representation might be worded as follows:

> We are not aware of any pending or threatened litigation, claims, or assessments or unasserted claims or assessments that are required to be accrued or disclosed in the financial statements in accordance with FASB Statement No. 5, and we have not consulted a lawyer concerning litigation, claims, or assessments.

[*The following are additional representations that may be applicable*.]

12. We are in agreement with the adjusting journal entries you have recommended, and they have been posted to the Association's accounts.
13. To the best of our knowledge and belief, no events have occurred subsequent to the balance-sheet date and through the date of this letter that would require adjustment to or disclosure in the aforementioned financial statements.
14. We have responded fully and truthfully to all inquiries made to us by you during your review.
15. The board of directors is collecting funds for major repairs and replacements in conformity with the Association's policy to fund for those needs based on a study conducted in November 20X7. The board of directors believes that the funds will adequately provide for future major repairs and replacements.
16. The board of directors has allocated the excess of the Association's revenues over its expenses during the current year to the fund for future major repairs and replacements.

XYZ CONDOMINIUM ASSOCIATION

Appendix C

Statement of Position 93-5

Reporting on Required Supplementary Information Accompanying Compiled or Reviewed Financial Statements of Common Interest Realty Associations

Notice to Readers

As part of the conforming changes to the AICPA Audit and Accounting Guide *Common Interest Realty Associations*, updated as of May 1, 2008, the Accounting and Review Services Committee, a senior technical committee of the AICPA, has rescinded SOP 93-5, *Reporting on Required Supplementary Information Accompanying Compiled or Reviewed Financial Statements of Common Interest Realty Associations*. Interpretative guidance previously included in the SOP has been conformed and moved to chapter 8 of the guide.

Appendix D

Information Sources

Further information on matters addressed in this guide is available through various publications and services listed in the table that follows. Many non-government and some government publications and services involve a charge or membership requirement.

Fax services allow users to follow voice cues and request that selected documents be sent by fax machine. Some fax services require the user to call from the handset of the fax machine, others allow the user to call from any phone. Most fax services offer an index document, which lists titles and other information describing available documents.

Electronic bulletin board services allow users to read, copy, and exchange information electronically. Most are available using a modem and standard communications software. Some bulletin board services are also available using one or more Internet protocols.

Recorded announcements allow users to listen to announcements about a variety of recent or scheduled actions or meetings.

All telephone numbers listed are voice lines, unless otherwise designated as fax (f) or data (d) lines. Required modem speeds, expressed in bauds per second (bps), are listed for data lines.

Information Sources

Organization	General Information	Other Services	Internet Web Site
American Institute of Certified Public Accountants	*Order Department* 220 Leigh Farm Road Durham, NC 27707-8110 (888) 777-7077	*Member Service Center* (888) 777-7077 *General Information* (919) 402-4500 *Accounting Standards Executive Committee* (212) 596-6167	www.aicpa.org www.cpa2biz.com
Financial Accounting Standards Board	*Order Department* P.O. Box 5116 401 Merritt 7 Norwalk, CT 06856-5116 (800) 748-0659	*General Information, including FASB and GASB technical inquiries* (203) 847-0700	www.fasb.org
Community Associations Institute	225 Reinekers Lane Suite 300 Alexandria, VA 22314 (703) 548-8600	*Annual Conference Registration* (703) 548-8600	www.caionline.org
National Association of Housing Cooperatives	1444 I Street, N.W. Suite 700 Washington, DC 20005-6542 (202) 737-0797	*Annual Conference Registration* (202) 737-0797	www.coophousing.org

Appendix E

Comparison of Key Provisions of the Risk Assessment Standards to Previous Standards

This appendix discusses the key provisions of each of the risk assessment related Statements on Auditing Standards (SASs) and provides a summary of how each of the SASs differs, if at all, from the previous AICPA generally accepted audit standards.

SAS No. 104, *Amendment to Statement on Auditing Standards No. 1,* Codification of Auditing Standards and Procedures *("Due Professional Care in the Performance of Work")*

Key Provisions	*How the SAS Differs From Previous Standards*
• SAS No. 104 defines *reasonable assurance* as a "high level of assurance."	• SAS No. 104 clarifies the meaning of *reasonable assurance*.

SAS No. 105, *Amendment to Statement on Auditing Standards No. 95*, Generally Accepted Auditing Standards

Key Provisions	*How the SAS Differs From Previous Standards*
• SAS No. 105 expands the scope of the understanding that the auditor must obtain in the second standard of field work from "internal control" to "the entity and its environment, including its internal control." • The quality and depth of the understanding to be obtained is emphasized by amending its purpose from "planning the audit" to "assessing the risks of material misstatement of the financial statements whether due to error or fraud and to design the nature, timing, and extent of further audit procedures."	• Previous guidance considered the understanding of the entity to be a part of audit planning, and emphasized that the understanding of internal control also was primarily part of audit planning. • By stating that the purpose of your understanding of the entity and its internal control is part of assessing the risks of material misstatement, SAS No. 105 essentially considers this understanding to provide audit evidence that ultimately supports your opinion on the financial statements. • SAS No. 105 emphasizes the link between understanding the entity, assessing risks, and the design of further audit procedures. It is anticipated that "generic" audit programs will not be an appropriate response for all engagements because risks vary between entities. • The term *further audit procedures*, which consists of test of controls and substantive tests, replaces the term *tests to be performed* in recognition that risk assessment procedures are also performed. • The term *audit evidence* replaces the term *evidential matter.*

SAS No. 106, *Audit Evidence*

Key Provisions	*How the SAS Differs From Previous Standards*
• SAS No. 106 defines *audit evidence* as "all the information used by the auditor in arriving at the conclusions on which the audit opinion is based."	• Previous guidance did not define audit evidence. • SAS No. 106 also describes basic concepts of audit evidence. • The term *sufficient, appropriate audit evidence,* defined in SAS No. 106, replaces the term *sufficient, competent evidential matter.*
• SAS No. 106 recategorizes assertions by classes of transactions, account balances, and presentation and disclosure; expands the guidance related to presentation and disclosure; and describes how the auditor uses relevant assertions to assess risk and design audit procedures.	• SAS No. 106 recategorizes assertions to add clarity. • *Assertion relating to presentation and disclosure* has been expanded and includes a new assertion that information in disclosures should be "expressed clearly" (understandability).
• SAS No. 106 defines *relevant assertions* as those assertions that have a meaningful bearing on whether the account is fairly stated.	• The term *relevant assertions* is new, and it is used repeatedly throughout SAS No. 106.
• SAS No. 106 provides additional guidance on the reliability of various kinds of audit evidence.	• The previous standard included a discussion of the competence of evidential matter and how different types of audit evidence may provide more or less valid evidence. SAS No. 106 expands on this guidance.
• SAS No. 106 identifies "risk assessment procedures" as audit procedures performed on all audits to obtain an understanding of the entity and its environment, including its internal control, to assess the risks of material misstatement at the financial statement and relevant assertion levels.	• SAS No. 106 introduces the concept of risk assessment procedures, which are necessary to provide a basis for assessing the risks of material misstatement. The results of risk assessment procedures, along with the results of further audit procedures, provide audit evidence that ultimately supports the auditor's opinion on the financial statements.

Key Provisions	*How the SAS Differs From Previous Standards*
• SAS No. 106 provides that evidence obtained by performing risk assessment procedures, as well as that obtained by performing tests of controls and substantive procedures, is part of the evidence the auditor obtains to draw reasonable conclusions on which to base the audit opinion, although such evidence is not sufficient in and of itself to support the audit opinion.	
• SAS No. 106 describes the types of audit procedures that the auditor may use alone or in combination as risk assessment procedures, tests of controls, or substantive procedures, depending on the context in which they are applied by the auditor.	• Risk assessment procedures include: — Inquiries of management and others within the entity — Analytical procedures — Observation and inspection
• SAS No. 106 includes guidance on the uses and limitations of inquiry as an audit procedure.	• Inquiry alone is not sufficient to evaluate the design of internal control and to determine whether it has been implemented.

SAS No. 107, *Audit Risk and Materiality in Conducting an Audit*

Key Provisions	*How the SAS Differs From Previous Standards*
• The auditor must consider audit risk and must determine a materiality level for the financial statements taken as a whole for the purpose of: 1. Determining the extent and nature of risk assessment procedures. 2. Identifying and assessing the risk of material misstatement. 3. Determining the nature, timing, and extent of further audit procedures. 4. Evaluating whether the financial statements taken as a whole are presented fairly, in conformity with generally accepted accounting principles.	• Previous guidance said that auditors "should consider" audit risk and materiality for certain specified purposes. SAS No. 107 states that the auditor "must" consider. • New guidance explicitly states that audit risk and materiality are used to identify and assess the risk of material misstatement.
• Combined assessment of inherent and control *risks* is termed the *risk of material misstatement*.	• SAS No. 107 consistently uses the term *risk of material misstatement*, which often is described as a combined assessment of inherent and control risk. However, auditors may make separate assessment of inherent risk and control risks.
• The auditor should assess the risk of material misstatement as a basis for further audit procedures. Although that risk assessment is a judgment rather than a precise measurement of risk, the auditor should have an appropriate basis for that assessment. • Assessed risks and the basis for those assessments should be documented.	• SAS No. 107 states that the auditor should have and document an appropriate basis for the audit approach. • These two provisions of the risk assessment standards effectively eliminate the ability of the auditor to assess control risk "at the maximum" without having a basis for that assessment. In other words, it is no longer acceptable to "default" to maximum control risk.

Key Provisions	*How the SAS Differs From Previous Standards*
• The auditor must accumulate all known and likely misstatements identified during the audit, other than those that the auditor believes are trivial, and communicate them to the appropriate level of management.	• SAS No. 107 provides additional guidance on communicating misstatements to management. • The concept of not accumulating misstatements below a certain threshold is included in the previous standards, but SAS No. 107 provides additional specific guidance on how to determine this threshold.
• The auditor should request management to respond appropriately when misstatements (known or likely) are identified during the audit.	• SAS No. 107 provides specific guidance regarding the appropriate auditor's responses to the types of misstatements (known or likely) identified by the auditor.

SAS No. 108, *Planning and Supervision*

Key Provisions	*How the SAS Differs From Previous Standards*
SAS No. 108 provides guidance on: • Appointment of the independent auditor. • Establishing an understanding with the auditee. • Preliminary engagement activities. • The overall audit strategy. • The audit plan. • Determining the extent of involvement of professionals possessing specialized skills. • Using a professional possessing IT skills to understand the effect of IT on the audit. • Additional considerations in initial audit engagements. • Supervision of assistants.	• Much of the guidance provided in SAS No. 108 has been consolidated from several existing standards. • However, SAS No. 108 provides new guidance on preliminary engagement activities, including the development of an overall audit strategy and an audit plan. — The overall audit strategy is what previously was commonly referred to as the audit approach. It is a broad approach to how the audit will be conducted, considering factors such as the scope of the engagement, deadlines for performing the audit and issuing the report, and recent financial reporting developments. — The audit plan is more detailed than the audit strategy and is commonly referred to as the audit program. The audit plan describes in detail the nature, timing, and extent of risk assessment and further audit procedures you perform in an audit. • SAS No. 108 states that you should establish a written understanding with your auditee regarding the services to be performed for each engagement.

SAS No. 109, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*

Key Provisions	*How the SAS Differs From Previous Standards*
• SAS No. 109 describes audit procedures that the auditor should perform to obtain the understanding of the entity and its environment, including its internal control.	• The auditor should perform "risk assessment procedures" to gather information and gain an understanding of the entity and its environment. These procedures include inquiries, observation, inspection, and analytical procedures. Previous standards did not describe the procedures that should be performed to gain an understanding of the auditee. • Information about the entity may be provided by a variety of sources, including knowledge about the entity gathered in previous audits (provided certain conditions are met), and the results of auditee acceptance and continuance procedures. • SAS No. 109 also directs the auditor to perform a variety of risk assessment procedures, and it describes the limitations of inquiry.
• The audit team should discuss the susceptibility of the entity's financial statements to material misstatement.	• Previous standards did not require a "brainstorming" session to discuss the risks of material misstatements. SAS No. 109 requires such a brainstorming session, which is similar to (and may be performed together with) the brainstorming session to discuss fraud.
• The purpose of obtaining an understanding of the entity and its environment, including its internal control, is to identify and assess "the risks of material misstatement" and design and perform further audit procedures responsive to the assessed risks.	• SAS No. 109 directly links the understanding of the entity and its internal control with the assessment of risk and design of further audit procedures. Thus, the understanding of the entity and its environment, including its internal control, provides the audit evidence necessary to support the auditor's assessment of risk.

(continued)

Key Provisions	*How the SAS Differs From Previous Standards*
• SAS No. 109 states the auditor should assess the risks of material misstatement at both the financial statement and relevant assertion levels.	• The previous standard included the concept of assessing risk at the financial statement level, but SAS No. 109 provides expanded and more explicit guidance. • SAS No. 109 also directs the auditor to determine how risks at the financial statement level may result in risks at the assertion level.
• SAS No. 109 provides directions on how to evaluate the design of the entity's controls and determine whether the controls are adequate and have been implemented.	• Under the previous standard, the primary purpose of gaining an understanding of internal control was to plan the audit. Under SAS No. 109, your understanding of internal control is used to assess risks. Thus, the understanding of internal control provides audit evidence that ultimately supports the auditor's opinion on the financial statements. • The previous standard directs the auditor to obtain an understanding of internal control as part of obtaining an understanding of the entity and its environment. SAS No. 109 requires auditors to evaluate the design of controls and determine whether they have been implemented. Evaluating the design of a control involves considering whether the control, individually or in combination with other controls, is capable of effectively preventing or detecting and correcting material misstatements. It is anticipated that this phase of the audit will require more work than simply gaining understanding of internal control.
• SAS No. 109 directs the auditor to consider whether any of the assessed risks are significant risks that require special audit consideration or risks for which substantive procedures alone do not provide sufficient appropriate audit evidence.	• Previous standard did not include the concept of "significant risks." • Significant risks exist on most engagements. • The auditor should gain an understanding of internal control and also perform substantive procedures for all identified significant risks. Substantive analytical procedures alone are not sufficient to test significant risks.

Key Provisions	*How the SAS Differs From Previous Standards*
• SAS No. 109 provides extensive guidance on the matters that should be documented.	• The guidance provided by SAS No. 109 relating to documentation is significantly greater than that provided by previous standards.

SAS No. 110, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*

Key Provisions	*How the SAS Differs From Previous Standards*
• SAS No. 110 provides guidance on determining overall responses to address the risks of material misstatement at the financial statement level and the nature of those responses.	• The concept of addressing the risks of material misstatement at the financial statement level and developing an appropriate overall response is similar to the requirement in previous standards relating to the consideration of audit risk at the financial statement level. However, that guidance was placed in the context of audit planning. SAS No. 110 "repositions" your consideration of risk at the financial statement level so you make this assessment as a result of and in conjunction with your performance of risk assessment procedures. In some cases, this assessment may not be able to be made during audit planning. • SAS No. 110 requires you to consider how your assessment of risks at the financial statement level affects individual financial statement assertions, so you may design and perform tailored further audit procedures (substantive tests or tests of controls). • The list of possible overall responses to the risks of material misstatement at the financial statement level also has been expanded.
• Further audit procedures, which may include tests of controls, or substantive procedures should be responsive to the assessed risks of material misstatement at the relevant assertion level.	• Although the previous standards included the concept that audit procedures should be responsive to assessed risks, this idea was embedded in the discussion of the audit risk model. The SASs repeatedly emphasize the need to provide a clear linkage between your understanding of the entity, your risk assessments, and the design of further audit procedures. • SAS No. 110 requires you to document the linkage between assessed risks and further audit procedures, which was not a requirement under the previous standards.

Key Provisions	*How the SAS Differs From Previous Standards*
• SAS No. 110 provides guidance on matters the auditor should consider in determining the nature, timing, and extent of such audit procedures.	• The new guidance on determining the nature, timing, and extent of tests of controls and substantive tests has been expanded greatly and addresses issues that previously were not included in the authoritative literature. • SAS No. 110 states that the nature of further audit procedures is of most importance in responding to your assessed risks of material misstatement. That is, increasing the extent of your audit procedures will not compensate for procedures that do not address the specifically identified risks of misstatement. • SAS No. 110 states that you should perform certain substantive procedures on all engagements. These procedures include: — Performing substantive tests for all relevant assertions related to each material class of transactions, account balance, and disclosure regardless of the assessment of the risks of material misstatements. — Agreeing the financial statements, including their accompanying notes, to the underlying accounting records — Examining material journal entries and other adjustments made during the course of preparing the financial statements

SAS No. 111, *Amendment to Statement on Auditing Standards No. 39,* Audit Sampling

Key Provisions	*How the SAS Differs From Previous Standards*
• SAS No. 111 provides guidance relating to the auditor's judgment about establishing tolerable misstatement for a specific audit procedure and on the application of sampling to tests of controls.	• SAS No. 111 provides enhanced guidance on tolerable misstatement. In general, tolerable misstatement in an account should be less than materiality to allow for aggregation in final assessment. • Ordinarily sample sizes for nonstatistical samples are comparable to sample sizes for an efficient and effectively designed statistical sample with the same sampling parameters.

Appendix F

Schedule of Changes Made to the Text From the Previous Edition

As of May 1, 2008

This schedule of changes identifies areas in the text and footnotes of this guide that have changed since the previous edition. Entries in the table of this appendix reflect current numbering, lettering (including that in appendix names), and character designations that resulted from the renumbering or reordering that occurred in the updating of this guide.

Terms Used to Define Professional Requirements

The 2008 editions of the AICPA Audit and Accounting Guides, including this guide, have been updated to conform with AU section 120, *Defining Professional Requirements in Statements on Auditing Standards*, AT section 20, *Defining Professional Requirements in Statements on Standards for Attestation Engagements* (AICPA, *Professional Standards*, vol. 1), and AR section 20, *Defining Professional Requirements in Statements on Standards for Accounting and Review Services* (AICPA, *Professional Standards*, vol. 2), in which professional requirements are categorized as either *unconditional requirements* or *presumptively mandatory requirements*, each of which is associated with specific wording such as *must* or *is required* or *should*. These standards distinguish *professional requirements* set forth in the standards from *explanatory material* contained in the standards, the latter of which requires only the auditor's, practitioner's, or accountant's "attention and understanding." Whether the auditor, practitioner, or accountant performs the suggested procedures or actions in the engagement (as stated in the explanatory material) depends on the exercise of professional judgment in the circumstances consistent with the objective of the standard.

Because interpretive publications (including AICPA Audit and Accounting Guides, for example) are recommendations, the publications cannot establish requirements. Paragraph .06 of AU section 150, *Generally Accepted Auditing Standards* (AICPA, *Professional Standards*, vol. 1), states, "The auditor should be aware of and consider interpretive publications applicable to his or her audit. If the auditor does not apply the auditing guidance included in an interpretive publication, the auditor should be prepared to explain how he or she complied with the SAS provisions addressed by such auditing guidance."

An interpretive publication, such as this guide, should state the requirement of the standard and then give recommendations on the application of the requirement in the specific circumstances. The terms *must*, *is required*, or *should* may be used in an interpretive publication only when it is clear that the requirement originated in a standard. Otherwise, the user may be uncertain whether a requirement or a recommendation is intended. The following conventions were used to conform the AICPA Audit and Accounting Guides to these standards, which define professional requirements:

- Terms to replace the use of *must*, *should*, and *is required* consist only of those explanatory material terms included in AU section 120, AT section 20, and AR section 20: *could*, *may*, and *might*, and these variations of those terms: *could consider*, *may consider*, and *might consider*.

- When referring guide users to interpretive publications, which consist of interpretations of the Statements on Auditing Standards (SASs), appendixes to the SASs, auditing guidance in AICPA Audit and Accounting Guides, and AICPA auditing Statements of Position (SOPs), or to nonauthoritative knowledge sources, if an auditor can perform an adequate risk assessment without the recommended knowledge, *explanatory material* terms are used; if not, *should* or *should consider* are used.
- Specific auditing procedures generally are explanatory in nature (the standards generally do not include specific audit procedures). As such, explanatory material terms (*could*, *may*, *might*, *could consider*, *may consider*, or *might consider*) are used, unless the specific audit procedure is the established way or only way of achieving a generally accepted auditing standard objective for this industry, in which case *should* is used.
- If the recommendation is that the auditor consult or familiarize himself or herself with other sources of information, such as Securities and Exchange Commission (SEC) regulations, income tax laws, and industry developments including regulatory, economic, and legislative developments, then the following considerations were used in developing which terms to use in the guides:
    - — If the purpose of the recommendation is for the auditor, practitioner, or accountant to develop the required understanding of the entity and its environment for risk assessment purposes, and an auditor can perform an adequate risk assessment without the recommended knowledge, *explanatory material* terms are used within the recommendation; if not, *should* or *must* is used depending upon the associated standard requirement.
    - — If the purpose of the recommendation is for the auditor, practitioner, or accountant to perform the engagement in accordance with AICPA *Professional Standards*, and the knowledge is available *only* from the source cited (such as SEC regulations, income tax law, and the like), then *should* is used. If the knowledge is available from other sources as well, *explanatory material* terms are used.
- The guides contain guidance for management, which includes best practices for the industry. Because the recommendations are best practices, the terms *ordinarily should* or *generally should* are used.

Reference	Change
Notice to Readers and Preface	Updated.
Paragraph 1.22	Revised for clarification.
Paragraph 1.24	Revised to reflect the appropriate use of terms used to define the professional requirements of auditors, practitioners, and accountants in AU section 120, AT section 20, and AR section 20 of AICPA *Professional Standards*.
Paragraph 1.26	Revised to define professional requirements.
Paragraph 2.12	Revised to reflect the issuance of FASB Statement No. 157.
Former footnote * in paragraph 2.12	Deleted.
Paragraphs 2.13–.17	Added to reflect the issuance of FASB Statement No. 157; added to reflect the issuance of FASB Statement No. 159; added to reflect the issuance of FASB FSP FAS 157-2.
Former footnote * in paragraph 2.18	Deleted.
Paragraph 2.18	Revised to reflect the issuance of FASB Statement No. 157.
Paragraphs 2.22 and 2.26	Revised to define professional requirements.
Paragraphs 2.27–.28	Added to reflect the issuance of FASB FSP AUG AIR-1.
Paragraph 3.02	Revised for clarification.
Paragraphs 3.03–.05	Revised to define professional requirements.
Paragraph 4.02	Revised for clarification.
Former footnote * in paragraph 4.07	Deleted.
Paragraph 4.07	Revised for clarification; revised to reflect the issuance of FASB Statement No. 159.
Paragraphs 4.09 and 4.16	Revised for clarification.
Paragraph 4.19	Revised to define professional requirements.
Paragraphs 4.21 and 4.24	Revised for clarification.
Paragraph 4.26	Revised to define professional requirements.

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Reference	Change
Paragraphs 4.28, 4.31, and 4.33–.34	Revised for clarification.
Paragraph 5.04	Revised for clarification.
Paragraph 5.09	Revised to define professional requirements.
Paragraphs 6.02–.03	Revised for clarification.
Paragraphs 6.06 and 6.10	Revised to define professional requirements.
Paragraphs 7.03, 7.06–.09, 7.12, 7.14, and 7.16–.17	Revised for clarification.
Paragraphs 7.21, 7.26, and 7.31	Revised to define professional requirements.
Paragraph 7.32	Revised for clarification.
Former footnote * in paragraph 7.32	Deleted.
Paragraphs 7.35–.36	Revised for clarification.
Paragraphs 7.37–.38	Revised to define professional requirements.
Footnote 4 to heading prior to paragraph 7.40	Added to reflect the issuance of TIS sections 8200.05–.09.
Paragraph 7.42	Revised to define professional requirements.
Paragraph 7.44	Revised for clarification.
Paragraphs 7.46–.47	Revised for clarification; revised to define professional requirements.
Paragraphs 7.48 and 7.54	Revised to define professional requirements.
Paragraph 7.60	Revised for clarification.
Former footnote † in paragraph 7.62	Deleted.
Paragraph 7.69	Revised for clarification.
Paragraphs 7.78–.79	Revised for clarification; revised to define professional requirements.
Paragraph 7.86	Revised for clarification.
Paragraphs 7.90–.93	Revised for clarification; revised to define professional requirements.
Paragraphs 7.95–.98 and 7.101–.102	Revised to define professional requirements.
Paragraph 7.103	Revised for clarification; revised to define professional requirements.

Reference	Change
Paragraphs 7.104–.106	Added for clarification.
Paragraph 7.107	Revised to define professional requirements.
Paragraph 7.109	Added for clarification.
Paragraph 7.110	Revised for clarification; revised to define professional requirements.
Paragraphs 7.111, 7.113, and 7.115–.116	Revised to define professional requirements.
Paragraph 7.121	Revised for clarification.
Paragraph 7.122	Revised to define professional requirements.
Paragraphs 7.124 and 7.129	Revised for clarification.
Footnote 1 to heading before paragraph 8.01	Revised for clarification.
Boxed text prior to paragraph 8.01	Added for clarification; added to reflect the rescission of SOP 93-5.
Paragraphs 8.02–.03	Revised for clarification; revised to define professional requirements.
Footnote 4 in paragraph 8.03	Added for clarification.
Paragraphs 8.04–.06	Added for clarification.
Former footnote 4 to heading before paragraph 8.04	Deleted for the passage of time.
Paragraphs 8.07–.09	Added for clarification.
Former footnote 5 to heading before paragraph 8.07	Deleted for the passage of time.
Paragraph 8.10	Revised for clarification.
Footnote * in paragraph 8.10	Added.
Former footnote 6 in paragraph 8.10	Deleted for the passage of time.
Former footnote * in paragraph 8.12	Deleted.
Paragraph 8.14	Revised for clarification; revised to define professional requirements.
Footnote † in paragraph 8.14	Added.
Paragraph 8.15	Added for clarification.
Paragraph 8.16 and 8.18–.19	Revised for clarification.
Footnote ‡ in paragraph 8.19	Added.
Paragraphs 8.23 and 8.25	Revised for clarification.

(continued)

Reference	Change
Footnote || in paragraph 8.24	Added.
Former footnote 8 to heading before paragraph 8.28	Deleted to reflect the rescission of SOP 93-5.
Paragraph 8.29	Revised to define professional requirements.
Former paragraphs 8.22–.26	Deleted to reflect the rescission of SOP 93-5.
Paragraphs 8.28–.32	Added for clarification.
Paragraphs 9.01 and 9.03	Revised to define professional requirements.
Paragraphs 9.18–.20 and 9.24	Revised for clarification.
Paragraph 9.26	Revised to define professional requirements.
Appendix A (introductory text)	Revised for clarification.
Appendix B	Revised to reflect the issuance of SSARS No. 17.
Appendix C	Revised to reflect the rescission of SOP 93-5.

Glossary

articles of incorporation. A document that creates the CIRA as a corporation under state laws.

assessment. A unit owner's proportionate share of the amount of money necessary to pay for the operation, administration, maintenance, and management of the common property, and to accumulate funds for future major repairs and replacements.

association. An organization of unit owners responsible for the operation, administration, and management of the common property. Generally, a not-for-profit corporation with membership of all owners.

board of directors. Individuals, usually unit owners, elected by members to govern the CIRA. (Also referred to as *board of managers, board of trustees, or board of governors.*)

bylaws. The governing rules of a CIRA dealing with routine operational and administrative matters. (Also referred to as the *code of regulations*.)

CC and Rs. See **declaration of covenants, conditions, and restrictions** and **declaration of condominium**.

capital expenditures. Funds expended for improvements or major repairs or replacements of common property components that extend their useful lives or service periods.

carrying charges. Charged to tenant-shareholders for operating and capital expenditures based on proprietary lease agreements, in cooperative housing corporations. (Commonly referred to as *rent*.)

CIRA. Common Interest Realty Association. An association, also known as a community association, responsible for the governance of the common interest community (CIC), for which it was established to serve. CIRAs are generally funded by its members via periodic assessments by the CIRA so that it can perform its duties, which include management services and maintenance, repair, and replacement of the common property, among other duties established in the governing documents and by state statute.

commercial unit. A unit in a CIRA, such as a store or office space, used exclusively to produce income.

common areas. See **common property** used with planned communities.

common elements. See **common areas** and **common property** used with condominiums and cooperatives.

common interest community. Real estate with respect to which a person, by virtue of his or her ownership in a unit, is obligated to pay for real estate taxes, insurance premiums, maintenance, or improvement of other real estate described in a declaration. The term *common interest community* (CIC) was first introduced in the 1994 amendment to the Uniform Common Interest Ownership Act (the Act) and creates one definition of those interests governed by the acts. This generic definition is used throughout the Act to refer collectively to the three particular forms of common interest community: (1) condominiums; (2) cooperatives; and (3) all other CICs that are not a condominium or a cooperative, such as a planned community.

common property. A CIRA's real or personal property to which title or other evidence of ownership is held (*a*) by individual members in common or (*b*) by the CIRA directly.

condominium. A form of ownership of real property that combines exclusive ownership of a defined space and an undivided interest in the common elements. (Also referred to as a *condo*.) A CIRA is not a condominium unless the undivided interests in the common elements are vested in the unit owners.

condominium association. See **association**.

converter. A person or entity that converts rental properties to CIRAs.

cooperative housing corporation. An entity established as a corporation that owns the real estate, usually a multi-unit dwelling, and all improvements on it and is responsible for its maintenance and payment of debt service. Ownership in the corporation is evidenced by shares of stock owned by tenant-shareholders who are entitled to occupy a unit under a proprietary lease. (Also referred to as a *coop.*) The individual ownership interests in most cooperatives are structured as personal property interests, but some are structured as real property interests.

declarant. A person or entity, generally the developer or converter, that legally establishes a CIRA by preparing and filing the required legal documents. (Also referred to as *sponsor for housing cooperatives*.)

declaration of condominium. A document that creates the condominium form of ownership and the association, and defines unit owners' undivided shares in the common property, membership and voting rights in the association, and covenants and restrictions on the use of units and common property. (Also referred to as the *CC and Rs* or *master deed*.)

declaration of covenants, conditions, and restrictions. Restrictive conditions in the owner's deed that limit the use of the common area. (See **declaration of condominium**.)

deed. A legal document that transfers to a unit owner title in a unit and an undivided interest in the common property.

deferred maintenance. Commonly used in the CIRA industry to refer to repairs and maintenance, which must be made periodically but not each year, such as painting.

documents. A set of papers creating and describing the CIRA, that may include such items as the declaration of condominium, articles of incorporation, bylaws, and leases or contracts entered into by the CIRA.

fiduciary duty. A special relationship of trust and responsibility held by the CIRA's board of directors towards unit owners.

homeowners' association (HOA). See **association**.

house rules. Guidelines prescribed by the bylaws or adopted by the board of directors for the use and operation of common property and for the conduct of unit owners on common property.

initial capital contribution. A term generally used in CIRA offering documents to refer to a one-time assessment paid by all original owners of units. (Sometimes referred to as *working capital*.)

major repairs and replacements fund. Money set aside for future major repairs and replacements of the common property that is separate from money used for operations. (Also referred to as a *reserve fund*.)

managing agent. A manager engaged by the board of directors to manage and operate the property and whose responsibilities usually include collecting and disbursing funds and supervising employees.

master association. An association formed for joint management of recreational facilities shared by several condominium associations.

master deed. See **declaration of condominium**.

mixed-use development. The result of land planning that combines space for residential and commercial use.

noneviction plan. An offering plan for conversion of a rental building to CIRA ownership in which nonpurchasing tenants need not vacate their units as a result of the conversion.

patronage dividend. Money that may be returned to coop members at the end of a fiscal year as a result of an excess of income over expenses.

percentage of ownership. The percentage of ownership interest of a unit in the common property used to determine a unit owner's share of common expenses.

planned community. A real estate development that consists of separate lots with contiguous or noncontiguous common areas and facilities owned and maintained by a CIRA in which owners have stock or a membership interest. Sometimes referred to as planned unit developments (PUDs), although the term planned unit development is more appropriately used as a zoning term.

proprietary lease. An agreement, which is renewed automatically, allowing a tenant-shareholder in a cooperative housing corporation to occupy a unit. (Also known as *occupancy agreement*.)

recreation lease. An agreement by which unit owners lease from the developer, or an unrelated third party, recreational facilities that were developed for use by unit owners but that are not a part of the common property.

rent. See **carrying charges**.

resale fee. A fee that may be charged by a CIRA for administrative expenses associated with the sale of a unit.

reserves. See **major repairs and replacements fund**.

special assessment. An assessment used for expenditures that were not included in the annual budget.

subscription agreement. An agreement to buy stock in a cooperative housing corporation.

tenant-shareholders. Owners of shares in a cooperative housing corporation who are entitled to occupy units under proprietary leases.

time-share association. See **time-sharing**.

time-sharing. Use of a unit for a designated period of time (usually expressed in terms of weeks) as a result of deeded ownership of a unit or a right-to-use evidenced by a long-term lease. Includes a requirement for participation in a proportionate amount of the costs of maintaining the property.

undivided ownership interest. Ownership in the common property that is inseparable and cannot be divided or severed.

uniform condominium act. The central source of condominium law.